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Introductory Comments

- Chairman Bachus, Ranking Member Sanders, members of the Subcommittee, on behalf of Bank of America, I thank you for the opportunity to provide our comments regarding the Basel II framework. I am Joseph Dewhirst and I am the Corporate Treasurer of Bank of America.

- Bank of America, with over $1 trillion in total assets, provides banking, investing, corporate and investment banking services and financial products to individuals and businesses across the United States of America and around the world. Within the U.S. itself, we have full-service consumer and commercial operations in 29 states and the District of Columbia.

- I intend to briefly summarize Bank of America's position on Basel II, including a review of progress to date, to discuss the implications of Basel II for the competitive environment, and to outline areas of continuing concern within each of the three pillars in the framework.

General Position

So let me begin by summarizing Bank of America's position on Basel II.

Direction

- The overriding concern of bank regulators is the safety and soundness of the banking industry. Bank management and shareholders naturally share this concern.
- Capital is a buffer against loss; and adequate capital is critical to the safety of a bank. It is sensible for bank management and for bank regulators to assess the adequacy of bank capital by looking at risk of loss.
- Bank regulators worldwide used Basel I to formalize the view that capital allocation should be risk-based and to define a method for assessing both risk and capital adequacy. This Capital Accord was, in our view, a major step forward in rationalizing the assessment of the capital adequacy of banks.
- Basel I was, nevertheless, only an initial step – an approximation to a true risk-based system. As the industry has developed more sophisticated methods for measuring risk, often dependent on computing power that has become available only during the last decade, there has been a growing need for more advanced regulatory capital requirements that more accurately reflect the increasingly complex risk profiles of the industry's largest banks and securities firms. Basel II is that more advanced approach.
- We strongly support the Basel II initiative, including the three-pillar paradigm of minimum capital requirements, supervisory review and market discipline as part of a comprehensive risk-based capital approach. We support the efforts to better align regulatory capital requirements to underlying economic risks, to encourage better risk measurement and management processes and to promote international consistency in regulatory standards.

<u>Progress made</u>

Next, let me give a brief assessment of progress made from our perspective:

- Our general view is very positive. Significant progress has been made toward a broadly accepted and reasonable basis to measure capital adequacy. Several of the more significant concerns of Bank of America were addressed as the Basel II proposals evolved from CP1 to CP3 and ultimately the US ANPR. The most important of these were the prescriptive nature of the proposals, the treatment of expected loss and the calibration for retail portfolios.
- We commend the Agencies' leadership in this process. While time-consuming and sometimes contentious, the consultative dialogue the Agencies have maintained with the industry has been mutually beneficial and has improved both the transparency of the process and the quality of the result.
- There are, nevertheless, several technical issues tied to the details of the calculations that still cause concern. As always, the devil is in the details. So we recognize that the Accord will continue to evolve. More important, the US Agencies are about to begin the fourth Quantitative Impact Study in the fall. We understand that another QIS may be scheduled for 2006. The additional year of impact studies and subsequent parallel reporting will, almost certainly, reveal areas requiring further research and modification to the rules. But we have every confidence that these details will be resolved before the final implementation date.

Operational risk

Some in our industry have raised questions about the capital requirements for operational risk.

- Bank of America strongly supports the Pillar I capital requirements for operational risk. The operational risk approach strengthens the overall risk-based capital framework, creates greater transparency than Pillar II alternatives and aligns the regulatory capital with industry best practice.
- We believe the Advanced Measurement Approach, which leverages the flexibility of internal methods in association with supervisory review, will allow for the most appropriate measurement and management of operational risk.
- We have already implemented explicit capital charges within our internal systems for operational risk. While some work remains, we believe these models are almost fully compliant with the AMA requirements. It would be disingenuous for us to take any position other than supporting the Pillar I approach within the Basel II framework.
- One need only look at recent history of the industry to find ample evidence that operational risk can be significant. It deserves the same rigor of analysis, governance and risk management process that is employed in the credit and market risk disciplines.

Impact on Competitive Environment

Let me turn next to the impact of Basel II on the competitive environment.

- We believe that changes in capital requirements will not materially alter the competitive landscape. The proposals will have a limited effect on the behavior of the banking industry. In particular, well-managed banks will not see significant change. To the extent that change does occur, it will follow from more prudent management of risk and more rational allocation of capital.

- Bank of America believes that good risk management provides a competitive advantage, irrespective of the regulatory capital framework. Therefore, we have invested significant time and resources to develop industry leading risk management processes and economic capital models.

- Correspondingly, Bank of America already manages its business activities on the basis of economic (or risk-based) capital, which is the core of Basel II. We believe that these tools enable us to make better risk and return decisions, enhancing the return on our capital investment. We apply this approach to pricing decisions, strategic planning processes, portfolio management activities, management reporting metrics and incentive compensation decisions. We already manage based on methods broadly consistent with Basel II. So our behavior is not likely to change in any material way.

- Banks that are not required to implement Basel II may elect to do so based on their own cost-benefit analysis. Since the new requirements will not alter the behavior of the more advanced banks with existing economic capital processes and because they are optional for other banks, we expect them to have no direct adverse effect on the competitive environment.

- Concerns have been raised regarding the prospects for industry consolidation as a result of Basel II. Of course, there are economies of scale in risk management. Good risk management has a cost, and it is easier to spread that cost over a larger base of assets. So at the margin, by encouraging good risk management, Basel II may encourage consolidation. But it will be insignificant compared to other drivers of consolidation, such as the economies of scale around product development, systems, and staffing as well as the benefits of diversification across business and geography.

Remaining Technical Concerns

As indicated, we have a number of technical concerns, which I will summarize here very briefly.

Pillar I: Capital Requirement

Under Pillar I, we have a number of concerns related to the capital requirement for credit risk:

- Proposed treatments of Expected Loss fail to recognize that banks already set product margins not only to compensate for expected loss and but also to earn a return. Capital for expected loss is not necessary.

- Caps on the resources considered as capital should be discarded. In particular, there should be no limit on the amount of reserves that qualify as capital, as the full amount of reserves is available to cover losses.

- The current approach to counterparty credit risk, which requires add-on factors for potential future exposure, is inconsistent with the best practices of leading banks.

- The current approach for recognizing the risk mitigation of credit derivative hedges is ineffective because it grossly overestimates the probability of a loss event.

- The treatment of maturity is particularly important for capital markets transactions. The current approach fails to recognize the reduced risk of assets with short-term tenors.

- Work remains to be done on the calibration of capital for mortgages and other retail assets. Through the use of conservative floors on the probability of default and loss given default, the current approach assumes that there is inherently more risk in these assets than seems justified.

Pillar II: Supervision and Coordination of Home & Host Regulatory Authorities

Under Pillar II, we have concerns related to home and host issues:

- The complexity of the new rules poses a particular challenge for international banks regulated in multiple jurisdictions. The Committee has adopted the principle of lead supervision, where the regulator in the bank's home country will coordinate information requests from host country regulators and play a leading role in the approval and validation of the capital models.
- We appreciate the elaboration of these high level principles. However, we are quite concerned regarding their implementation in practice.

Pillar III: Disclosure Requirements

Under Pillar III, we have a concerns related to disclosure requirements:

- We agree that disclosure has an important role to play in the effective implementation of the Accord. We appreciate the steps taken to reduce the amount of required disclosure, but we believe that the disclosure requirements remain excessive. The risk of misinterpretation of this complex and detailed information will far outweigh its potential benefit. Transparency would be better achieved by the clear presentation of more limited but important information than by the publication of large amounts of data.

We provide detail regarding these and other concerns in an attached written appendix.

Summary

In closing, let me again thank you for this opportunity to express our views. Let me assure you that we strongly support the objectives of Basle II, and we have been pleased with the process and progress to date. While we recognize outstanding issues, we believe these issues can be resolved satisfactorily. Finally, we believe that Basel II will encourage better management of risk and more rationale allocation of capital in the banking industry.

Appendix I

Areas of Significant Progress

- One of our early concerns was the prescriptive nature of the proposals when CP3 was published. We commend the Agencies for adopting a principle-based approach in crafting the Advanced Notice of Proposed Rulemaking and Draft Supervisory Guidance for implementation in the US. We believe only a principles-based approach will be flexible enough to accommodate the continuing evolution of risk management and the development of new financial products.
- We were also quite concerned regarding the treatment of expected loss in the overall framework. The committee's decision to eliminate the capital requirement for expected loss was a significant advance toward a true risk-sensitive capital framework. With the proposed elimination of expected loss, the framework for the <u>measurement of risk</u> is now more closely aligned with the best practices of the industry. Unfortunately, the proposed treatment also includes offsetting changes in the <u>determination of actual capital</u> and fails to address longstanding issues regarding regulatory capital definitions and limitations on qualifying capital. We continue to believe these issues warrant further consideration and modification before final implementation.
- We also felt that the calibration of capital requirements for retail portfolios was not aligned with the underlying economic risks. Without getting into too much technical detail, the calibration did not adequately represent the level of diversification inherent in a retail portfolio. The Committee has resolved this issue with a new calibration for credit card portfolios which is much more in agreement with industry experience.

Appendix II

Details of Remaining Technical Issues

<u>Treatment of expected losses</u>

- The recent proposal to remove expected loss from the capital requirement does indeed reduce the divergence between the industry and regulatory measures of risk. However, the proposal also contains a deduction from actual capital for expected loss (EL). The two treatments of EL – as a component of the risk measure or a deduction from actual capital – are ultimately equivalent. Both treatments fail to recognize that banks consider expected loss to be a cost of doing business and set product margins to not only compensate for expected loss and but also earn a return on capital.

- Our formal comment recommended the adoption of the industry approach, which recognizes that product margins are set so that FMI will compensate for EL and therefore neither adds EL to the capital requirement nor deducts it from capital. If the Committee prefers to retain an explicit treatment of EL, this can best be accomplished either by restricting the EL deducted from reserves to that of non-performing loans or by allowing explicit estimates of FMI to offset EL, subject to appropriately conservative haircuts.

- The notion of caps or restrictions on the amount of resources that may be considered as capital should be discarded. In particular, there should be no limit on the amount of reserves that qualify as capital, as the full amount of reserves is available to cover losses.

<u>Counterparty Credit Risk</u>

- We are aware that the Basel Committee and IOSCO have established a working group to review the method for calculating the capital charge for counterparty credit risk. The current approach that requires add-on factors for potential future exposure is inconsistent with the best practices of leading banks.

- Regulatory capital should move away from the current add-on approach in favor of exposure measures based on internal models. Banks use well established market risk models to estimate exposure profiles for each counterparty and account for cross product netting agreements, diversification across risk factors, and applicable collateral agreements. These models are implemented with the same standards of accuracy as market risk models and already subject to stringent model validation processes.

<u>Limited Recognition of Credit Risk Hedging</u>

- The current approach for recognizing the risk mitigation of credit derivative hedges is ineffective. It attempts to capture the benefits of credit risk hedging and guarantees through substitution of the default probability of the guarantor for that of the borrower when determining risk weightings. It fails to recognize that the obligor and the guarantor must both default for a bank to experience a loss on a hedged exposure. The odds of such an event are considerably less than a default of either entity in isolation.

- We believe this approach is far too conservative and should be changed. The proposal is inconsistent with the stated objective of promoting better risk management practices and could send inappropriate signals regarding the value of risk mitigation. Consider the case of an exposure to a AA rated industrial company which is hedged in the credit derivative market with a AA rated bank as the counterparty. Under the proposed substitution approach, the risk mitigating value of the hedge would simply not be recognized.

- Bank of America supports the approach for reflecting credit hedges developed by the Federal Reserve. We believe the FRB approach can be implemented with the same standard of accuracy as any other element of the AIRB approach.

Limitations in maturity adjustments

- The treatment of maturity is particularly important for capital markets transactions. The current approach fails to distinguish the risks of assets with short-term tenors. We believe these restrictions should be removed and that the maturity adjustment should be open-ended to be consistent with industry practice.

Retail Calibration

- Recently, the committee has addressed this concern for credit card portfolios. Unfortunately, concerns remain regarding the calibration of capital assignments for mortgages and other retail assets. These concerns center around the use of conservative floors on the default probability and loss given default parameters and the overall level of correlations on these products.

Appendix III

Details of Disclosure Issues

- We agree with the importance of market discipline and believe that disclosure has a very important role to play in the effective implementation of the Accord. We appreciate the steps taken to reduce the amount of required disclosure. Unfortunately, the disclosure requirements are still grossly excessive. The risk of misinterpretation of this information and the burden its distribution will place upon banks far outweigh its potential benefit.

- Transparency is better achieved by the clear presentation of important information than by the publication of large amounts of data. The possibility for unintended consequences of excessive disclosures should be given greater consideration. Our local examiners have the historical context and sufficient knowledge of the institution to correctly interpret this information. Many market participants, on the other hand, lack the same depth and breadth of understanding. Rather than encouraging market discipline, the proposed volume of disclosure will slow the absorption of information by the market and increase the likelihood of inappropriate or contradictory conclusions by investors.

- The effort required to amass the sheer volume of data, prepare it for presentation and provide explanatory comments will make it nearly impossible to meet the deadline of 30 days following quarter-end for Call Report and SEC filings that will be effective by the time Basel II is implemented. It is essential that investors be provided with the appropriate level of information at the right time. Under the current Basel I regime, we are able to present risk-based capital ratios and supporting detail when we announce earnings. The proposed level of disclosure is inoperable within that same timeframe. As a result, the presentation of capital adequacy information will be delayed and the timeliness of our disclosures will suffer.

- Corporations have a valuable role to play in summarizing and analyzing data for their shareholders. The Agencies, in association with the industry and the investor community, should identify a smaller subset of key disclosures that will appropriately convey a bank's risk profile without inundating the user with irrelevant information or risking misinterpretation. Any remaining disclosures should be left to the judgment of the institution based on the demands of their investors, the relevance of the information to the current financial condition of the bank and the state of the overall economic environment.