SunTrust

Testimony of

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Of the
U.S. House of Representatives

On

The New Basle Accord:
Private Sector Perspectives

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INTRODUCTION:

Mr. Chairman and members of the committee, I am very pleased to have the opportunity to discuss SunTrust Banks' view of the proposed capital accord. I am Sandra W. Jansky, Executive Vice President and Chief Credit Officer for the company. I have been in the banking industry for thirty-four years, almost totally in lending and credit risk management functions. I have been employed with SunTrust Banks, Inc. for twenty-three years. My current responsibilities with the corporation include management of all aspects of credit risk for the company; that includes credit approval, credit policy and administration, workouts, credit risk rating methodology, credit analytics and management information reporting for credit risks as well as the credit review function. I am a member of the company's management committee, strategic integration committee and I chair the Basel II Steering Committee for compliance with the new accord. I also had the privilege of serving as the immediate past chairman of the Risk Management Association.

SunTrust Banks, Inc. (STI) is the seventh largest domestic bank in the US with assets of $125 billion. We have 1,201 offices located in eleven states from Maryland to Florida and we have approximately 27,000 employees. As of December 31, 2003 SunTrust had total assets under advisement of $181 billion that included $159 billion in trust assets and $22 billion in brokerage assets. Our loan portfolio is approximately $82 billion and our mortgage servicing portfolio is approximately $70 billion. SunTrust is considered by many of our peers, regulators and Wall Street analysts to be a conservative financial institution that has consistently demonstrated best in class asset quality since our inception.

In my comments today, I will address our reasons for choosing to become an "opt-in bank," our view of the positive aspects of the accord and issues that we continue to believe are problematic such as operational risk, commercial real estate treatment, treatment of home equity and disclosure requirements for Pillar III.

GENERAL POSITION:

The stated purpose of the New Accord is to more closely align the overall level of regulatory capital with the risks taken on by financial institutions. The goal is to require financial institutions to use industry best practices to measure, mitigate and manage risks. As a conservative financial institution we strongly embrace efforts that encourage banks to improve their risk management process.

Our financial institution believes it is imperative that we comply with the provisions of the Basel II accord. As a conservative risk taker we believe we have been required to hold excessive regulatory capital without true consideration for the composition of risk in our institution. If there is an opportunity to better align regulatory capital with the economic capital required by public markets, we want to be able to qualify for such treatment. Our belief is that lower risk banks should hold lower capital and higher risk banks more capital. That would allow regulators and others to distinguish the more conservative and predictable financial institutions from those that have somewhat volatile swings in performance due to higher risk profiles.

We believe we must move forward quickly to meet the requirements under the accord due to our size. We will be approximately $145 billion in assets by the end of third-quarter this year. Due to the complexity and vast requirements under the accord, it is impractical for our institution to delay compliance with the proposal. As the second largest Federal Reserve Board regulated institution in the country, we need to continue to pursue advanced risk management practices. We believe delays would further increase our costs of compliance. We also believe we could be at a competitive disadvantage compared to "core banks" if they are able to operate with lower capital levels than SunTrust. This impacts our cost to deliver credit products in the market and the overall risk adjusted returns of those products. As you know, financial institutions with assets in excess of $250 billion and/or international assets in excess of $10 billion are defined as "core banks" by the U.S. regulators. SunTrust Banks is an "opt-in bank" which has made our efforts to meet the accord requirements challenging. As an "opt-in bank" we are not at the table with the core banks and senior regulators as issues are explored and recommendations made on a wide variety of issues. Additionally, core banks have the advantage of more focused regulatory assistance as they pursue the Advanced Internal Ratings Based (AIRB) status. "Opt-in banks" need additional guidance and assistance from the regulators that is not readily available today.

The most significant feature of the proposed accord for STI has been the introduction of a two-dimensional risk rating system. We began development of a two-dimensional risk rating system in 1999. We will complete our final rollout of the system, known in our company as PRISM, by the end of this year. We have seen enormous benefit not only in the risk management areas of the company but also in our lines of business. This more robust risk rating system has allowed us to develop a much more detailed understanding of the risks in our portfolio across all lines of business. We have trained numerous employees on the concepts of obligor rating (probability of default) and facility rating (loss given default). This has led to the development of better pricing models in our institution and a better understanding of the risk/return opportunities in our marketplace. We see tremendous possibilities with the new ratings methodology.

We believe the two-dimensional risk rating system, transparency of the risk rating system, data maintenance and model validation aspects of the accord are all positive. I would hasten to add that these have been implemented at considerable costs to our financial institution and there will be significant costs built into our ongoing budget processes to maintain the rigor of the process.

TECHNICAL ISSUES:

As much as we like certain aspects of the accord, the overly prescriptive requirements as well as level of complexity will continue to challenge us as we continue to move towards Advanced Internal Ratings Based status. We continue to remain concerned about the special treatment provisions required for certain specialized lending areas such as commercial real estate. While some change has been announced to the original proposal, we believe that the higher capital requirements for certain asset types without regard for the specific risk management practices of a particular institution remain problematic. We have yet to see empirical evidence that would support the proposed higher requirements for certain classes of commercial real estate. With arbitrary capital minimums established for certain product types, the loans may not make the required return rates (internal hurdle rates) to satisfy profitability return requirements. This could lead to less supply for this type of credit by financial institutions. Simply put credits that the regulators delineate as higher risk might become too costly for banks to provide. This could lead to more volatility in the availability of credit to support construction and development projects in various markets across the United States. Again, SunTrust is a very conservative underwriter not only in credit origination but also in the ongoing monitoring of risks inherent in credit extended.

We are also concerned about the correlation requirements for residential real estate and home equity lines and loans vs. credit card portfolios. Home Equity Lines of Credit (HELOCs) that are required to be treated as exposures backed by residential mortgage are subject to a minimum LGD of 10% and an asset correlation of 15%. Credit cards have a (very low) 4% correlation. These asset correlations are to be used regardless of the quality of the individual credits. The proposed treatments will impact the costs of credit availability to product lines that have grown tremendously over the last ten years. Home equity lines and loans have provided very affordable access to credit for millions of consumers. The correlation requirements proposed could result in higher capital to secured equity products than unsecured credit card products. Again, there is no distinction between the risk management, underwriting and mitigants used by different institutions. Our actual loss experience in these products is significantly below the minimum requirements.

OPERATIONAL RISK:

Of all the changes required for advanced status under Basel II, the most significant is in the quantification of operational risk. Operational risk quantification has been largely rule of thumb without the accuracy of market or credit risk quantification. Though there has been improvement in the field since the first release of the accord, operational risk quantification is still far behind the other two and it will take some time to bridge that gap. This is highlighted by the lack of guidance in Basel II documentation and the ANPR in the area of operational risk quantification. While we understand the challenges the regulators face in providing meaningful guidance, it is a significant concern that we are this close to the implementation date and there is no widely accepted approach to estimating operational risk capital. Given the amount of set-up time required to accurately make these estimates, both in terms of data requirements (and the need for long time series of data) and the development of institutional knowledge, this places banks in a very difficult position.

The Federal Reserve has taken the position that the Advanced Measurement Approach (AMA) is the only acceptable approach to calculating operational risk regulatory capital and is therefore required if a banks wants to the use the Advanced Internal Ratings Based approach to credit capital. While we understand their argument that the Basic and Standardized approaches are not accurate, we believe this might place the American banking industry at a competitive disadvantage. If we at SunTrust can satisfy the requirement for the Advanced Internal Ratings Based approach for credit risk and fail to meet the currently unspecified requirements for Advanced Measurement Approach for operational risk, we will be forced to use the current approach (Basel I) for both credit and operational risk.

A similar bank in another country would have the ability to use the AIRB approach for credit risk and the Basic or Standardized approach for operational risk. We believe this represents a potential disadvantage to U.S. banks working diligently to comply with the operational risk requirements of the accord. Given the crude nature of the development of operational risk quantification, holding credit risk hostage to operational risk seems a significant mistake. If a bank is able to show that it is in the process of implementing a sound operational risk management system, it should be allowed to use the Advanced Internal Ratings Based (AIRB) for credit, and for a temporary period, use the Basic or Standardized approach to operational risk.

DISCLOSURE REQUIREMENTS:

The disclosure requirements of Pillar III seek to enhance market discipline through increased public disclosure. In our 2003 annual report we provided thirty-eight pages of additional disclosure addressing all aspects of risk in our institution. Our annual report including all the required financial and regulatory disclosure is now 100 pages in length. While transparency and disclosure are admirable goals, the Pillar III proposals will add a substantial amount of very technical disclosures that we believe will be difficult for readers to comprehend. The requirements are specific to provide a regulatory view of risk. We are very concerned not only about the prescriptiveness of the required disclosures but also the fact it does not provide the flexibility necessary to make adjustments as risk management practices evolve.

SUMMARY & RECOMMENDATIONS:

SunTrust Banks, Inc. believes the new accord is a very positive step in the right direction. We commend the regulators, members of this committee and the International committee for the progress that has been made to date. We do believe the U.S. regulators should consider the following recommendations:

1. Establish a working group of the "opt-in banks" to further enhance the ability of those banks that have committed substantial human capital and financial resources to meet compliance with the accord. These banks are getting too little assistance today so the regulators can guarantee compliance by the "core banks."

2. U.S. regulators should allow banks to qualify for the Advanced Internal Ratings Based capital approach for credit risk and allow operational risk requirements to be met under the Basic or Standardized approach to be utilized in non-US. countries. There would be substantial incentive for the U.S. banks to work to comply with the advanced status for operational risk while giving them sufficient time to thoroughly implement the program requirements.

3. Asset correlations assigned to certain consumer products need to be revisited to make sure they make sense as you look at the risk issues associated with like products. The asset correlations proposed appear to be inconsistent. Or, an alternative would be to let us treat Home Equity Lines of Credit (HELOCs) as Qualifying Revolving Retail Exposure (QRRE).

4. Address the complexity and magnitude of additional technical disclosures required under Pillar III.

Thank you for the opportunity to present our issues and views around the proposed capital accord.

APPENDIX:

SECURITIZATION:

While correct conceptually, the differentiation in the higher credit grades (AAA and AA) is not meaningful. It is not until the exposures become A or worse that the resulting risk weights are meaningful.

Currently, many investors do not have the information required to calculate underlying exposures, as they are not readily available in the servicing reports. Since N is relatively easy to calculate, with access to the information, it should be simple enough for servicers to provide the calculation in most deals. Vendor analytics programs can supply the necessary information to calculate information internally for most, but not all, deals.

The securitizations have performed well in the risk ratings purchased by SunTrust. We feel comfortable that rating agencies know how to structure the securitizations appropriately. Recent events, however, have sensitized the market to the general issues of operational and servicer risk associated with these transactions; these risks are difficult to separate from the performance of the structure and the underlying collateral, as they are so often entwined. Defined as Credit Risk in the ANPR, the inherent risks associated with the credit of the servicers (fraud, solvency, and collections) is not always reflected in the rating in a timely fashion as the servicer deteriorates financially.

OPERATIONAL RISK: COMPETITIVE EQUITY

The implementing bodies in the United States should allow banks with a well-developed implementation plan for the Advanced Measurement Approach (AMA) for measuring operational risk capital to use the Advanced Internal Ratings Based approach to measure credit risk capital until completion of this plan.

A significant difference between the American implementation of the new Basel Capital Accord (New Accord) and that of other nations as outlined in the ANPR is the elimination of two potential approaches to measure minimum levels of operational risk capital, the basic indicator approach (BIA) and the standardized approach (see section 1C of Attachment 1). This difference is important due to the broad approach of the A-IRB. Under the A-IRB, minimum regulatory capital is derived solely from the credit risk of the underlying exposures, with no "gross-up" for operational risk (as exists under the current framework). As a result, for a bank to use the A-IRB, it is necessary that it also have a mechanism for calculating minimum levels of operational risk capital. The New Accord approaches this problem by giving banks a menu of possible approaches to calculating operational risk capital, from the exceedingly simple (the BIA) to the complex (the AMA). In the ANPR, American banks are restricted to using the AMA. Though we understand the rationale for this choice, we strongly disagree with it, and would like to offer an alternative proposal.

SunTrust's concern lies ultimately on the varying levels of development of quantitative, capital-based risk management methodologies in the areas of credit and operational risk. Quantitative credit risk management is a well-developed field, with widely agreed upon methodologies and the general opinion that, even if not immediately available to all institutions, adequate data is obtainable to accurately parameterize the models used to estimate the tail events that drive capital levels. By 2007, a bank that started developing a modern credit risk ratings system following the initial Consultative Paper of the

New Accord should have adequate systems, models, and data to allow for the implementation of the A-IRB.

A similar level of development does not exist in the area of Operational Risk Management (ORM). ORM is a new field, and the basic questions as to the best approaches for issues such as capital measurement have not been agreed upon. For example, the relative value of internal data vs. external data vs. "scenario analysis", and methodologies for converting external data into something usable internally, are undecided.

This disparity in development places institutions, and regulators, in an awkward position. Banks are concerned that their investments in measuring credit risk will not fully pay off, as they will be denied A-IRB status because they have not yet achieved AMA status. Regulators are forced to emphasize development of an untested operational risk methodology. We believe the following proposal largely eliminates these problems without giving up the benefits that are associated with implementing the AMA.

Regulators should allow banks to use the A-IRB approach to estimate credit risk capital and use the BIA or the standardized approach to calculate operational risk regulatory capital as long as the following conditions are met:

a) The bank is in compliance with all areas under the titles "Corporate Governance" and "Operational Risk Management Elements", as specified by the Supervisory Guidance on Operational Risk/Advanced Measurement Approaches for Regulatory Capital
b) The bank has an implementation plan for the AMA that has well-developed and transparent milestones
c) The bank is capturing internal operational risk data, and effectively using internal data, external data, business environment and internal control factor assessments, and scenario analysis in the management of operational risk throughout the bank

By meeting these conditions, the bank shows that it has a well-developed approach to measuring and managing operational risk, which should be the primary goal of the regulation. It is reasonable on the part of the bank to expect to be recognized for these efforts by the regulatory bodies by gaining access to the new regulatory regime, and by recognizing such efforts the regulators create a system of incentives that would lead to a reduction in operational risk system-wide.

We understand that the BIA and standardized approaches are not accurate measures of operational risk, and used continuously could lead to very poor sets of incentives. This is why we support only temporary use of these measures. For a period of a few years, with a clear end point, the benefits that arise from using the A-IRB far outweigh the negatives associated with the BIA and standardized approach.

<u>Our proposal bears consideration for the following reasons:</u>
Competitiveness of the American banking industry: We strongly support the basic philosophy behind the New Accord: capital should be aligned to risk, and the models actually used by the banks best measure this risk. We believe that the New Accord will improve the efficiency and competitiveness of banks that can use the advanced approaches to measuring risk, by incenting them to take on economical risks, and

rewarding (or punishing) them for the actual risk associated with their decisions. In our opinion, banks that are permitted to use, in particular, the A-IRB approach will be at a genuine competitive advantage to those that will not, and a banking system consisting of said institutions will be both more profitable and more stable.

The current state of regulatory capital measurement leads to an inevitable split between economic and regulatory capital management. This results in a conflict between the regulators and the shareholders, and banks perform a wide variety of convolutions to balance the demands of the two, resulting in decreased profitability and increased instability of the system. The A-IRB approach to measuring regulatory capital will go a long way towards alleviating this problem. Banks using the approach will achieve consistency between their economic and regulatory capital measures. The benefits are significant. By aligning the interests of shareholders and regulators, there will no longer be a conflict between maximizing profits and maximizing stability.

By eliminating the option of all non-AMA approaches to measuring operational risks, American regulators run the risk of holding the A-IRB, and its widespread benefits, hostage to a poorly understood approach to measuring operational risk capital. This would create a system that disadvantages American banks by continuing the split between internal and external measures of risk, resulting in a banking system that is both less profitable and less stable then those in other nations. We do not think this is a desirable goal.

<u>FINANCIAL DISCLOSURE:</u>
SunTrust is concerned with the quantitative disclosure in two respects. The first is that enhanced disclosure does not translate into improved transparency; due to the complexity of the underlying theory and the Accord itself, these disclosures have the potential to be read by few and understood by even less.

The second deals with the matter of proprietary information regarding the nature of specific portfolios and the potential to provide competitors with more meaningful information than our investors and creditors. As competitors, we follow each other's loan pricing closely. With sufficient granularity of portfolios in the reports and the necessary quantitative metrics, we understand each others' businesses well enough that it would be possible to reverse engineer the assumptions underlying the pricing models, in particular, the perspective of credit risk for particular asset class.

To assuage these concerns, we would propose that a working group be formed, comprised equally of bank representatives, unaffiliated analysts, rating agencies, and regulators to create a standard reporting format. The objective would be to provide meaningful statistical information that can be used by readers to understand the capital levels, as well as their changes from period to period. The information should be sufficient to meet their needs, while not compromising proprietary pricing strategies and practices. The latter two of the working group - regulators and rating agencies - could potentially receive a more detailed schedule of the public summary.

Use of the Advanced Internal Ratings Based approach for credit risk will increase the current time required preparing the Call Report and the FRY9-C. The new disclosure requirements conflict with the initiative to shorten the filing deadlines for these reports.

While it seems that the Annual Report would be a good vehicle for required disclosures, the volume of additional disclosures would add multiple pages to bank's reports that are already in excess of 100 pages and do not serve as easily interpretable shareholder information. We do not think creating a separate document is the answer either. Preferable would be a new page added to the FRY-9C that would disclose sections (a) and (b) from Table 6 from the Basel Third Pillar. This would verify whether the bank's regulatory supervisors had approved the ratings approach and would briefly describe the ratings system. We believe the remainder of table 6 detailing the internal rating system would not add value to the market participant's decisions. For the details we believe the market participants can rely on the supervisory validation.

We feel the SEC's rules for Management Discussion and Analysis would require SunTrust to discuss the bank's approach to assessing the adequacy of capital to support current and future activities, including SunTrust's approach under Basel to assess and manage risk. If the regulators believe the SEC's rules regarding MD&A would not satisfy the disclosures as prescribed by Basel, then additional guidance would be needed.

The requirement to describe the entities comprising a company's consolidated banking group does not give enough guidance. This list for all large banks would be extensive and overwhelming. We suggest limiting the list by using only those entities that meet a designated percentage of total assets or income.