November 3, 2003

Federal Reserve Board
Attn: Vice-Chairman Roger W. Ferguson, Jr.
Copy to regs.comments@federalreserve.gov

Office of the Comptroller of the Currency
Attn: Comptroller John D. Hawke, Jr.
Copy to regs.comments@occ.treas.gov

Federal Deposit Insurance Corporation
Attn: Chairman Donald E. Powell
Copy to comments@fdic.gov

Office of Thrift Supervision
Attn: Director James E. Gilleran
Copy to regs.comments@ots.treas.gov

RE: Supplemental Comment on Basel II's Advance Notice of Proposed Rulemaking

Dear Sirs:

Our first comment letter, submitted July 18, 2003 described in detail our concerns about the proposed Basel II capital regime. Among other things, inordinately complicated risk-based rules and the resulting "black box" models will be virtually impossible to regulate and monitor effectively, and ultimately will result in the nation's largest banks sinking to the lowest levels of capital possible.

While we reaffirm our earlier comment letter (attached) and continue to believe that the proposed Basel II regime is incompatible with promoting safety and soundness in the banking system, we wish to highlight the following points.

(1) A mandatory leverage requirement needs to be maintained.

We strongly agree with the position articulated in the ANPR that the existing leverage ratio requirements, in addition to prompt corrective action legislation and implementing regulations, should be maintained even if Basel II is adopted, including a minimum 5% leverage ratio, to be classified as "well-capitalized." However, it is essential that there be legislation or binding provisions that would prohibit the leverage ratios from being reduced or waived without some high level of review and action, possibly an act of Congress or the unanimous approval of a designated group, such as the Chairman of the FDIC, the Chairman of the Federal Reserve Board and the Secretary of the Treasury. Experience suggests that banks inevitably will opt for lower capital in order to achieve higher returns on equity.

Many commentators have criticized the current capital regime, claiming it is susceptible to arbitrage. We believe that Basel II's risk-based regime will be even more easily gamed unless leverage ratios are also in place. Minimum leverage ratios should be the foundation of any capital regime, with risk-based rules existing to impose additional capital requirements for riskier assets. Among other things, the leverage ratio ensures that, regardless of the risk-based model used by a bank or the manipulation we think will be endemic under Basel II, there is at least a base level of protection in the event of a crisis, rather than relying primarily on an insurance fund or a taxpayer bailout.

Taking the residential mortgage industry as an example, Basel II would cause risk-based capital levels for residential mortgages to fall well below most leverage ratios. Such a result could be disastrous for the mortgage industry in the absence of a leverage ratio. While we agree that mortgage lending can operate at a high level of safety when prudently managed and supervised, complexities abound and significant downturns in the mortgage industry have occurred, and will continue to occur, when potential regulatory lapses are combined with low capital requirements. Ironically, 30 years ago, it was the failure to understand these complexities that caused the United States to give unreasonably favorable treatment to mortgages, and to allow marginal players to operate with minimum levels of capital. And then, when a large part of the thrift industry failed, the industry was roundly criticized for the folly of not having had adequate capital to back up their activities. Basel II's risk-based rules use the same wishful thinking that was used 30 years ago in the United States to justify unreasonably low capital levels for mortgage activities without regard to the relevant complexities.

In addition, the existing regulatory capital ratios should be strengthened to prevent financial institutions from selling assets off-balance sheet and lowering their capital requirements even though the probability of loss remains the same. It is nonsensical that a bank should gain a capital advantage simply by shifting assets from one pocket to another (see the attached for a simple illustration). This type of manipulation would be an even greater problem after Basel II where risk-based capital levels for some asset classes will fall well below most leverage ratios, if leverage ratios are in place at all. Accordingly, Basel II delegates should ensure that the capital levels required for off-balance sheet transactions, including securitizations, are clearly specified and tested against a range of scenarios.

(2) Basel II's regime would have competitive implications and a destabilizing effect.

Since capital is a key driver of return-on-equity, and a major focus of investors, banks continually measure, manage and massage capital to improve their market position. Basel II's internal ratings-based (IRB) approaches will give banks a powerful tool to manipulate capital levels and try to improve their profits relative to their competitors. The result will be a race toward the lowest amount of capital reserves, thereby distorting the purpose of a capital regime. The lower capital levels that Basel II banks obtain will also threaten the viability of those banks that remain subject to Basel I's higher capital thresholds, because these Basel I banks will either become attractive takeover targets or they will find it more difficult to compete for quality assets, leaving them with riskier assets, lower credit ratings and higher costs of funding.

(3) U.S. regulators should consider whether Basel II improves the stability of the U.S. and international banking systems.

While we can appreciate that there is a significant amount of political momentum moving Basel II toward adoption, especially in light of the sunk costs already devoted to the new accord and the exhaustion and/or frustration of the participants, we would urge U.S. regulators to avoid being swept up by the push to get something done and to consider instead whether Basel II will actually improve the stability of the U.S. and international banking systems.

We continue to wonder why U.S. regulators would acquiesce to the complex rules and self-directed models being advocated by international delegations with significantly less successful banking systems. Our national banking system has, over the past 30 years, been far more stable than those abroad, in large part because our prior bank and thrift crises produced a stronger regulatory framework and because we benefited from capital rules that are simple enough to be understood by management, applied consistently across all institutions, and monitored effectively by regulators and other market participants. Again, have we forgotten that complex rules and race-to-the-bottom incentives lead to mischief and quickly spiral into full-blown crises, irrespective of the sophistication of advanced models? The reality is that no one will know how good the models are until the next crisis. Regardless of whether international banking systems adopt Basel II, we suggest that the U.S. should not subject the safety and soundness of its banking system to the proposed new rules.

We are not opposed to well-reasoned changes to the current Basel I capital accord. However, given the importance of capital rules and the consequences if mistakes are made, we recommend evolutionary changes rather than a revolutionary approach that would allow banks to determine their own capital requirements. We continue to believe that the more responsible approach would be to improve the supervisory process and re-examine and adjust, as appropriate, Basel I's risk-weights and categories.

Sincerely,

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Herbert M. Sandler
Chairman and Chief Executive Officer

Exhibit A
Selling Assets Off-Balance Sheet and Reducing Capital Requirements

Scenario A: On-Balance Sheet

Scenario A shows the capital requirement for a bank that is holding $1,000,000 of qualifying 1-4 family residential mortgage loans on its balance sheet. We are assuming a minimum regulatory capital percentage of 8%.

Asset value:	$1,000,000
Risk-weighting:	50%
Regulatory %:	8%
Capital requirement:	**$40,000**

Scenario B: Selling Assets Off-Balance Sheet while Retaining Small Recourse Tranche

Scenario B assumes that the bank decides instead to sell 90% of those same assets off-balance sheet, while retaining only a 10% recourse tranche on-balance sheet.

90% Off-Balance Sheet Tranche		10% Recourse Tranche	
Asset value:	$900,000	Asset value:	$100,000
Risk-weighting:	0%	Risk-weighting:	100%
Regulatory %:	8%	Regulatory %:	8%
Capital requirement:	$0	Capital requirement:	**$8,000**

As shown above, the bank would reduce its capital requirement to $8,000 by retaining only a 10% recourse tranche. One might argue that this capital reduction is appropriate since the bank now only holds 10% of the assets. The problem, however, is that the bank's 10% tranche may in fact bear the same probable risk of credit loss as the bank would bear under Scenario A, but with significantly less capital to support the same level of risk. For example, the transaction can be structured so that the bank's 10% tranche is a credit enhancement tranche in a first-loss position, meaning the tranche bears the first 10% of credit losses. So, even though the 10% tranche might end up absorbing most, if not all, of the credit risk of the $1,000,000 in assets, and even though the probability of the bank's credit loss remains the same between Scenario A and B, the bank would be able to save $32,000 in capital. And, of course, if the bank were to recycle the $900,000 in proceeds from the off-balance sheet sale into more loans, and restructure those new loans into additional Scenario B transactions, it quickly becomes apparent that very low levels of capital will be available to support an ever-expanding loan portfolio.

While this is obviously an over-simplified example, it illustrates one of the many ways a bank could reduce its capital requirements even though the same underlying assets are involved and the bank has an equivalent risk exposure. And this example does not even touch upon the bank's continued exposure under representations and warranties or other informal guarantees that are often used in structured transactions.