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Docket No. R-1238

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Overview

This letter responds to the interagency request for comment on the notice of proposed rulemaking for Basel IA. It also comments on where we feel proposed Basel II regulations will impact non-Basel II banks. In general, we support the use of economic capital by management and regulators. However, as with the Basel II ANPR, we have some concerns about a fair and equitable application of varying capital standards.

Regulatory capital is a useful measure, in large part because it is consistently calculated across all organizations. Some of the current proposals, however, could lead to a US banking landscape with five different capital calculations: Advanced Basel II banks, Foundation IRB Basel II banks, Standardized Basel II banks, Basel IA banks, and Basel I banks. Each calculation has different assumptions and requirements. All of these proposed measures omit coverage of certain risks (liquidity, ALM, reputational) from Basel II. In such a capital regime, regulator subjectivity will play a large role in determining capital adequacy and fairness. We feel it is important that large, complex banking organizations be held to a high risk management standard, consistent with many of the Basel II principles. The Pillar II "cushion" should be large enough to cover the "worst case" losses that approved Basel II models fail to incorporate. While smaller banks should be encouraged to improve their risk management standards, they should be permitted a standardized approach requiring less robust and expensive models and data collection. Overly granular

requirements may simply add cost and spurious precision. We feel some of the data requirements implicit in the NPR for Basel IA could add cost with limited value.

To better explain our concerns with Basel IA and the accompanying Basel II proposals, we comment on several questions below.

Question 1: The Agencies welcome comments on all aspects of these proposals, especially suggestions for reducing the burden that may be associated with these proposals. The Agencies believe that a banking organization that chooses to adopt these proposals will generally be able to do so with data it currently uses as a part of its credit approval and portfolio management processes. Commenters are particularly requested to address whether any of the proposed changes would require data that are not currently available as part of the organization's existing credit approval and portfolio management systems.

- After reviewing the proposed changes, we found several information gaps in our data.
 - A) We have no database of guarantor or collateral financial details or ratings, making it laborious and expensive to incorporate into a regulatory capital model. Furthermore, initial evidence suggests that even if such a database were in place, so little collateral and so few guarantors would have external ratings, that we would get no capital relief for even high quality collateral and guarantors.
 - B) Reflecting our propensity to sell mortgage assets, we employ no quantitative grading system for mortgages. As a result, there is no credit history available by rating for mortgages. While recent payment history is recorded, there is no non-accrual data available.
 - C) We do not track the ratings of the PMI insurer's, though we do know the name of the insurer at the loan level.
 - D) Though the small business proposition would be beneficial, we lack sufficient historical information to test that the loans meet the requirements for capital relief. Financial statements are not kept in any database, so testing for a debt coverage ratio of 1.3 would not be practical. Guarantor information is also not warehoused. The LTV field is not updated on the system at this point, so historical analysis would not be possible.

Question 2: The Agencies seek comment on all aspects of the proposal to allow banks to opt in to and out of the proposed rules. Specifically, the Agencies seek comment on any operational challenges presented by the proposed rules. How far in advance should a banking organization be required to notify its primary Federal supervisor that it intends to implement the proposed rule? If a banking organization wishes to "opt out" of the proposed rule, what criteria should guide the review of a request to opt out? When should a banking organization's election to opt in or out be effective? In addition, the Agencies seek comment on the appropriateness of requiring a banking organization to apply the proposed Basel IA capital rules based on a banking organization's size, level of complexity, risk profile, or scope of operations.

- As mentioned in previous correspondence, BOKF endorses capital requirements that better discriminate between risks. Banks with lower risk profiles should benefit from capital relief. Separating higher from lower risk profiles is the principal challenge of an effective capital regime. Banks will select the regime that minimizes their capital requirement. We are concerned that the lowest capital regime might not, in fact, incent the lowest risk profile. A bank would choose to opt out of new regimes if 1) their capital increased more than expected given the risks, or 2) if the extra effort and data required for Basel IA does not provide capital relief. We believe regulators should permit opt outs

liberally. Basel I has proven effective for nearly 20 years, including two recessions, the Asian Contagion and tech bubble. Remaining on Basel I will not leave the banking system undercapitalized. We feel it important, however, that banks which choose to opt out initially should be permitted to opt in at later dates

- If larger banks are permitted to use the Standardized or Foundation approaches of Basel II, we believe *any* bank should be able to opt in to the appropriate version of Basel II. Banks would need to meet the standards for the chosen version, but they would not necessarily need to meet the current Basel II opt in requirements regarding size and complexity.
- Opt out requests should be acted on within 30 days of request to permit denied banks more time to modify their data collection to comply with Basel IA or one of the allowed Basel II options.
- For those organizations with significant non-traditional mortgages and higher risk mortgages (higher LTV), Basel IA should be required. In these cases, we believe Basel I offers the lowest capital option, but not the lowest risk profile.

Question 4: The Agencies solicit comment on all aspects of the proposed use of external ratings including the appropriateness of the risk weights, expanded collateral, and additional eligible guarantors. The Agencies also seek comment on whether to exclude certain externally rated exposures, collateral, and guarantees. Alternatively, should the Agencies retain the existing risk-based capital treatment for certain types of exposures, for example, qualifying securities firms? The Agencies are also interested in comments on all aspects of the scope of the terms sovereign, non-sovereign, and securitization exposures. Specifically, the scope of these terms, whether they should be expanded to cover other entities, or whether any entities included in these definitions should be excluded.

- We do not feel that the proposed use of external ratings, expanded collateral, and additional eligible guarantors will provide any significant benefits, but could impose significant costs. The infrastructure investment needed to create a collateral and guarantor database, coupled with the ratings research and maintenance mechanism would outweigh any benefits (capital relief, or improved risk management) as so few will have external ratings. Further exclusions would only add to the regulatory burden without any potential return.

Question 9: While the Agencies are not proposing to use LTV and borrower creditworthiness to risk weight mortgages, the Agencies may decide to risk weight first lien mortgages based on LTV and borrower creditworthiness in the final rule. Accordingly, the Agencies continue to seek comment on an approach using LTV combined with credit scores for determining risk-based capital. More specifically, the Agencies seek comment on: operational aspects for assessing the use of default odds to determine creditworthiness qualifications to determine acceptable models for calculating the default odds; the negative performance criteria against which the default odds are determined (that is, 60 days past due, 90 days past due, etc.); regional disparity, especially for a banking organization whose borrowers are not geographically diverse; and how often credit scores should be updated. In addition, the Agencies seek comment on determining the proper credit history group for: an individual with multiple credit scores, a loan with multiple borrowers with different probabilities of default, an individual whose credit history was analyzed using inaccurate data, and individuals with insufficient credit history to calculate a probability of default.

- While BOKF does not track credit scores on our mortgages because we sell over 80% of them, we do feel it appropriate to discriminate mortgages by risk of repayment. High

LTV and debt service (including maximum debt service) mortgages should require greater capital and might have fended off the current subprime mortgage event.

- While we concede that borrower creditworthiness is a relevant consideration over time, due to the substantial operational procedures and infrastructure required to establish, track, and update the metrics, a materiality standard should be in place. Mortgage portfolios under, for example, 10 percent of assets, should be exempted from the need to track borrower creditworthiness as the likely capital impact would be minimal.
- We observe that from the lender's standpoint for conventional mortgages, interest rate risk is considerably greater than credit risk, but none of the five capital regimes discussed in this letter address interest rate risk.
- To be consistent with our economic capital model, we would choose non-acrual (90 days past due) as the point of default.

Question 11: The Agencies request comment on all aspects of PMI including, whether providers must be non-affiliated companies of the banking organization. The Agencies also seek comment on the treatment of PMI in the calculation of LTV when the PMI provider is not an affiliate, but a portion of the mortgage insurance is reinsured by an affiliate of the banking organization.

- We believe it is appropriate to give capital relief by reducing the LTV with PMI if, and only if, the PMI provider is not affiliated with the bank and has low credit risk itself. This same principal would apply to the portion of the mortgage reinsured by an affiliate. Capital relief should not be given if the credit risk of high LTV is not truly transferred.

Question 12: The Agencies seek comment on the proposed risk-based capital treatment for all mortgage loans with non-traditional features and, in particular the proposed approach for mortgage loans with negative amortization features. The Agencies also seek comment whether the maximum contractual amount is the appropriate measure of the unfunded exposure to loans with negative amortization features. The Agencies seek comment on whether the unfunded commitment for a reverse mortgage should be subject to a similar risk-based capital charge.

- As discussed above, we believe many of these mortgage loans with non-traditional features pose significant risks to financial institutions. As such, it is appropriate to hold more capital against these loans. We feel that the increased risk weight for the unfunded portion of the loan is a reasonable way to charge more capital without increasing the burden significantly.

Question 17: The Agencies seek comment on this or other approaches that might improve the risk sensitivity of the existing risk-based capital rules for small loans to businesses.

- We do believe that loans backed by the Small Business Administration warrant a lower risk weight. In addition, any loans meeting the requirements set forth in Basel IA would also warrant a lower risk weight, though our current data infrastructure would not be sufficient to monitor compliance with the requirements and we would get no capital relief until our data collection and management is enhanced. Interestingly, preliminary research suggests that the potential capital relief benefit is not sufficient to cover the additional systems and personnel costs required to implement a collateral/guarantor and financial statement tracking and warehousing system.

Question 19: To what extent should the Agencies consider allowing Basel II banking organizations the option to calculate their risk based capital requirements using approaches

other than the Advanced Internal Ratings Based (A-IRB) approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?

- As mentioned above, banks will select the capital regime that minimizes regulatory capital. We believe that Basel II's advanced model approach affords the greatest potential for reducing regulatory capital, and in previous correspondence, we have recommended that Regulators use their Pillar II subjectivity to avoid a bifurcated banking system with lower credit quality assets concentrating in smaller banks. We therefore expect that permitting core banks to use a Standardized or Foundation approach would serve merely as an interim point until these core banks build up sufficient data, expertise and systems to move to the advanced approach. Importantly, we also feel that non-core Basel II banks should also be permitted to employ a Basel II Standardized or Foundation approach. The bar for permitting this should be lower than for the advanced approach. As mentioned above, banks that initially choose to remain on Basel I or IA should be given an opportunity to subsequently "move up" to a Standardized or Foundation approach.

Question 20: If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the Standardized approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?

- We believe that all three options offer banks opportunities to achieve capital relief for lower risk profiles. Our analysis and economic capital experience suggest that greatest relief would be available to the Advanced Basel II approaches. Large, complex organizations can afford the human and systems resources to run such models. They should be permitted to use a Standardized or Basel IA approach but would likely gravitate to the more advanced model because the derivative treatment in Basel IA is too onerous. If there were any modifications to the Standardized approach or Basel IA, such modifications should also be available to smaller organizations.
- Regarding alternative derivative exposures treatment, we would recommend greater capital relief for credit or risk-equivalent measures on derivatives that have no marginal credit exposure. For example, floating for fixed swaps combined with a floating rate loan have no greater credit exposure than a fixed rate loan. Similarly, a commodity swap hedging collateral for a production loan adds no additional credit exposure if the swap shares the collateral with the loan. For these positions, we argue that the existing 50 percent limit is too stringent based upon the negligible marginal risks of these derivatives. Nearly all of the risk for these instruments is contained in the loan. For some derivative products, Basel IA increases the 50% to 100%, exacerbating the overstatement of risk and resulting regulatory capital.

Question 21: The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking organizations to calculate capital requirements for exposure to both credit risk and operational risk. If the Agencies were to proceed with a rulemaking for a U.S. version of a Standardized approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?

We believe that banks should hold capital to cover their operating risks. With Basel I and IA, the credit capital charge cushion inherent in risk weights is sufficient to cover operating risk. We have not studied the effect of the Standardized Basel II approach on BOK, but note that the operating risk component would represent approximately ten percent of our total regulatory capital. If core banks were permitted to employ a Standardized Basel II approach without an operating risk component they would have a significant advantage over Basel I and Basel IA banks.

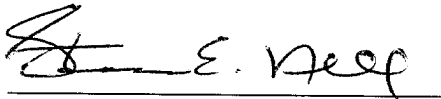
Conclusion

In our comments on the 2003 Basel II ANPR, we expressed concern regarding the competitive implications of a bifurcated capital regime. Our concern was that core Basel II banks would be allowed to hold lower capital for high quality loans than non-core banks. This could lead to a banking industry where high quality credits are concentrated in the largest banks while mid-size and community banks can only bid for lower quality credits.

Though we continue to believe that a risk-based approach to capital is appropriate, Basel IA does little to address the competitive landscape. Basel IA does appear to be more risk-sensitive, but is too highly reliant on external ratings and on uncollected detailed financial information as a proxy for risk for regional banks to achieve meaningful capital relief. Thus, we do not feel that Basel IA reduces the potential economic advantage that an Advanced Basel II respondent could have over a Basel I or IA respondent.

If current core Basel II banks will be allowed to utilize the Standardized or Foundation Approaches of Basel II, we believe that the most equitable US solution would be to allow non-core banks the time and opportunity to migrate to the lower Basel II tiers as well. Basel I should remain in effect until the transition is economically practical for mid-size banks. In this way, there is at least the option for these banks to join a globally competitive capital regime. Over time, the disparity between the US and European implementation would erode; mid-sized banks would be allowed to find the level of capital regime that best balances between risk-sensitivity and effective management; and finally, mid-size banks would be able to combat aggressive pricing from core Basel II banks for high credit quality customers.

Sincerely,



Steven E. Nell