1120 Connecticut Avenue, NW
Washington, DC 20036

1-800-BANKERS
www.aba.com

World-Class Solutions, Leadership & Advocacy Since 1875

Paul A. Smith
Senior Counsel
202-663-5331
psmith@aba.com

Robert W. Strand
Senior Economist
202-663-5350
rstrand@aba.com

March 26, 2007

Via email

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller
of the Currency
250 E Street, SW
Mail Stop 1–5
Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th St. & Constitution Ave., NW
Washington, DC 20551

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications; 71 Federal Register 77446; December 26, 2006; **FDIC:** RIN 3064-AC96; **FRB:** Docket No. R-1238; **OCC:** Docket No. 06-15; **OTS:** Docket No. 2006-49

Ladies and Gentlemen:

The American Bankers Association ("ABA") appreciates this opportunity to comment on the Notice of Proposed Rulemaking ("NPR") to revise the risk-based capital standards, as issued by the Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision (collectively, the "Agencies"). The intended purpose of the proposed revisions is to enhance the risk sensitivity of the current rule without unduly increasing regulatory burdens for banks and banking firms that elect to adopt the new system ("Basel IA") instead of remaining subject to the current version ("Basel I"). Further, the proposed revisions are intended to address potential competitive disadvantages that could result when some banking organizations move to a system that originated in the international "Basel II" accord ("Framework").[1]

[1] The Agencies have proposed rules to apply the Framework Advanced Approaches. The Framework can be found at: Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards: A Revised Framework*, June 2004 (www.bis.org/publ/bcbs128.pdf). For the U.S. proposal, see: Federal Deposit Insurance Corporation, Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision, "Risk-Based Capital Standards: Advanced Capital Adequacy Framework;" 71 Federal Register 55830; September 25, 2006 (www.fdic.gov/regulations/laws/federal/2006/06proposeAC73.pdf).

ABA represents more than two million men and women who work in the nation's banks. ABA brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional, and money center banks and holding companies, as well as savings associations, trust companies, savings banks, and bankers banks – makes ABA the largest banking trade association in the country.

ABA believes that it is critically important that a workable Basel IA standard be developed and implemented. To be workable, Basel IA must provide meaningful improvements in risk sensitivity with minimal increases in regulatory burdens. However, ***ABA concludes that the proposed standard does not satisfy this criterion or offer a useful alternative to the current risk-based capital rules.*** Few banks would choose the Basel IA option as proposed. The NPR needs to be amended to reflect the way banks manage and mitigate risk. To be a worthwhile alternative for more than a limited number of mortgage-oriented banks, the Basel IA rule should be amended from the NPR to:

- provide lower risk weights for residential mortgage (first and subordinate liens) and commercial real estate loans;
- reduce the risk weights and relax the qualification requirements for small business loans and multi-family residential mortgages;
- expand recognition of collateral and guarantees, to include all that can be legally perfected and objectively valued (whether or not it is connected with a rating); and
- allow banks, as an option, to factor into risk weightings consumer credit scores, loan seasoning, and reappraisals of property value.

At the same time, ***the current Basel I standard provides a strong capital requirement that optimally minimizes the reporting burden for many banks and should therefore be retained as the base capital standard for those banks that elect to continue to be subject to it.***

For a number of large regional and some nationwide institutions, neither Basel I nor Basel IA is a viable option. These banks will need much more risk-sensitive regulatory capital when some banking firms move to the Advanced Approaches under Basel II. They might elect to adopt the Basel II Advanced Approaches themselves, were it not for the prohibitive cost. ***To have an optimal set of capital standards for these banking firms, it is critical that the Standardized Approaches under the Framework be developed.***

I. General Comments

I.A. A multi-tiered capital standard is needed in the U.S.

When discussion began in the late 1990s on reform of the international accord on capital standards, the Agencies elected to apply the revised Basel II rule taking into consideration the unique structure of the U.S. banking industry. In most of the other nations working on Basel II, the banking industries were (and are) composed of a small number of relatively large institutions. In contrast, in this country there were (and are) thousands of banks, about half of which hold under $100 million of assets. Consequently, the Agencies decided then to adopt in this country only the Advanced Approaches of Basel II, applied only to the largest banking organizations.

When, two years ago, trial runs suggested that the Advanced Approaches could significantly lower capital requirements for these large banking firms, ABA stated and the Agencies agreed that reforms were needed for the capital standard for the rest of the industry as well. This led to the Basel IA proposal, a step which ABA firmly supports in principle.

Yet ever since the Basel I capital standard was first applied in the early 1990s, many banks have felt that the relative non-complexity of their operations and their high levels of capital relative to assets warrant no risk-based capital rule at all. Nonetheless, these banks have been required to develop Basel I systems and are raising no objection to continuing to use them. Therefore, ABA and these banks have asked that they be permitted to continue operating under Basel I and not be forced to develop new risk-based capital systems, which would be of little benefit and significant cost to them. ***ABA applauds the provision in this proposal that would not require banks to adopt Basel IA systems.***

However, there have been major changes in the U.S. banking structure since the 1990s. Today there are 119 banks with over $10 billion of assets. While these banks are developing more advanced risk measurement and management systems, many of these institutions cannot afford the tremendous cost of implementing the Advanced Approaches. For these banks, something more than Basel IA, but less than the Advanced Approaches, is warranted. We believe that the Standardized Approaches from the Framework fit this need. ***It is critical that the Agencies move forward with the Standardized Approaches, without which there will be no good alternatives for many banks.***

U.S. Banking Industry		
	1999	2006
All Banks	**10,220**	**8,681**
Asset Size		
Under $100 Million	**5,821**	**3,633**
Over $10 Billion	**78**	**119**
Data from the FDIC		

In sum, the U.S. needs a multi-tiered menu of options for risk-based capital standards in order to accommodate the structural diversity of the U.S. banking industry without creating competitive inequities, including:

- Basel I as the base standard;
- Basel IA with more risk-sensitive capital and additional documentation of risk mitigating factors;
- the Standardized Approaches in the Framework, which would be even more risk-sensitive and would include all of the operational risk approaches from the Framework; and
- the Advanced Approaches – harmonized with the Framework.[2]

I.B. The Agencies must develop a workable Basel IA rule.

Most community bankers find little in the Basel IA standard as proposed that reflects the actual risk of their portfolios, and they would elect to stay on the current Basel I standard. Few small banks hold rated securities, make loans to rated firms, or have exposures that are guaranteed by rated entities. Thus, most community bankers believe that the NPR fails to accommodate how they manage and mitigate risk exposures. Some appreciate the increased sensitivity for residential mortgages, but even here they see the proposed risk weightings as still excessive. Without further tailoring of the NPR, it would not be worth the extra reporting trouble

[2] Bankers that have reviewed the Agencies' proposal for the Advanced Approaches have concerns about the extent to which the U.S. version differs from the Framework. This issue is discussed in detail in our comment on that proposal.

except for some of the relatively few institutions that retain a significant amount of residential mortgages in portfolio.

A significant number of community bankers believe that it is critically important that a workable Basel IA rule be developed, with increased risk sensitivity and minimal additional reporting, to allow their banks to continue to be competitive when some institutions adopt one of the Basel II approaches. For many banks, the current rule is growing increasingly obsolete, given advances in data and monitoring even at small banks. Moreover, the Basel I risk weights have never closely corresponded with their charge-off experience.

Further modifications to the Basel IA proposal must be made for it to be sufficiently attractive for banks to migrate from Basel I to Basel IA. The final rule should be revised from the NPR with lower risk weights for quality mortgages and small business loans, and expanded recognition of collateral, guarantees, and (optionally) other risk mitigants. ABA is committed to working with the Agencies in developing a workable Basel IA system and to keep it up-to-date as systems and data improve.

I.C. The Standardized Approaches in the Framework should be an option.

Similarly, most of the banking organizations that will consider using the Advanced Approaches find the proposed Basel IA standard to be too rudimentary to match their activities. These organizations price loans with regard to capital. Thus, those that do not adopt the Advanced Approaches are justifiably concerned that they will lose business to those that do – simply because they could have to hold more capital, unrelated to risk, for the same exposures. Many of these organizations have found the Advanced Approaches to be prohibitively expensive and overly restrictive, as proposed, for their needs. With neither the Advanced Approaches nor the Basel IA NPR's rule as viable alternatives, these organizations are left without a capital standard suited to their business.

As a solution, ***ABA strongly recommends that the Agencies adopt the Standardized Approaches from the Framework as an option.*** The Framework would attach an operational risk component to the capital requirement for credit risk. The Agencies have proposed not to include an operational risk component for the Basel I or IA approaches, and ABA agrees. However, conversations with the institutions interested in the Standardized Approaches indicate that they can accept an operational risk component – provided that they are allowed to use any of the Framework's approaches for operational risk.

II. Answers to the Questions Posed

Question 1: The Agencies welcome comments on all aspects of this proposal, especially suggestions for reducing the burden. [Would] any of the proposed changes … require data that are not currently available as part of the organization's existing credit approval and portfolio management systems?

The point of the Basel IA alternative is to increase the risk sensitivity of the existing capital standard. Bankers are willing to accept some increase in reporting – and ancillary responsibility for verification during examinations – in order to achieve the added risk sensitivity.

The proposed risk weighting using loan-to-value ("LTV") ratios for residential mortgages satisfies this tradeoff for some banks that hold meaningful amounts of such assets in portfolio. ***Bankers support use of LTV ratios for risk weighting residential exposures.***

In order to further the goal of more risk-sensitive regulatory capital, the Agencies need to identify the range of collateral and guarantors used by bankers. In particular, for business lending, the risk weightings should recognize verifiable guarantees by high net-worth individuals as well as the protections provided by business property and equipment. Use of consumer credit scores would appear to add greatly to the regulatory burden for capital calculation, and most bankers oppose such an addition. In particular, they would object to having to go to the time and cost to update credit scores continually over the life of the loan. However, some institutions use this data in monitoring risk. For institutions that are willing to compile, report and defend their data, this information should be incorporated into risk weightings.

Importantly, all Basel IA adopters should have the option to use these added data items or not. This optionality would allow users to balance the gain in regulatory capital sensitivity against the compliance burden. From the Agencies' perspective, the optionality would allow – in fact encourage – progressive step-ups in risk sensitivity for regulatory capital, thereby furthering the stated goal of better aligning risk sensitivity to levels of regulatory capital.

II.A. Opt-In Proposal

Question 2: The Agencies seek comment on all aspects of the proposal to allow banks to opt into and out of 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 opt 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 asset size, level of complexity, risk profile, or scope of operations.

The Basel I capital standard has clearly served as an important regulatory paradigm since it was introduced in 1990. For the last 17 years, bank capital has grown steadily while bank failures have become almost non-existent. While many banking firms now need a more risk sensitive rule in order to compete, clearly the Basel I system is a workable base system. Therefore, ***ABA recommends that there be no size or complexity test that requires a bank to operate under Basel IA standard.*** The Agencies should permit every bank to choose the option best suited to its operations.

If the Agencies adopt changes suggested by the industry to make the Basel IA rule workable, then many banks will opt into that standard. Similarly, if the Agencies make the Standardized Approaches from the Framework available in this country, as we also request, then a number of institutions will elect to move to that standard.

Once a bank determines which capital standard best suits its business model, the only prerequisite for electing a risk-based capital option should be the institution's ability to demonstrate to examiners that it can reliably provide the information needed to comply with the standard chosen. For example, the Basel IA option would involve new items in the Call Report, such as reporting

residential mortgage loans by LTV bucket. A bank wishing to apply the Basel IA standard should be permitted to do so as soon as it is able to provide the new items in the Call Report.

There should be similar flexibility if a bank elects to shift its capital regime back to a version used earlier. It is difficult to conceive of a situation where it would be worth the trouble and expense for a bank to arbitrage back and forth between capital regimes. Certainly, such action would trigger closer supervisory review. Therefore, there is no need for the Agencies to impose some artificial time limit on opting out of Basel IA or eventually the Standardized Approaches.

II.B. Number of Risk Weight Categories

Question 3: The Agencies seek comment on whether [the proposed] or any other new risk weight categories would be appropriate… The Agencies are interested in any comments regarding whether any categories of assets might warrant a risk weight higher than 200 percent and what risk weight might be appropriate for such assets. The Agencies also solicit comment on whether a ten percent risk weight category would be appropriate and what exposures should be included in this risk weight category.

Bankers believe that, despite some proposed reductions, the risk weights in the NPR would still be excessive for good quality assets. ***ABA requests that the Agencies estimate and validate risk weightings with the same degree of rigor that examiners expect for bank risk management systems. Bankers are convinced that the results of this research – which should be published for review – would justify lower risk weightings for many assets.***

Bankers appreciate reductions in risk weights for residential mortgages but, based on their experience with these assets, believe that their good quality mortgage and commercial real estate loans deserve still lower risk weightings than in the NPR. They recommend that the entire schedule for residential mortgages be shifted down. The lowest LTV category should be risk weighted no more than 10 percent. However, we believe that validation would justify an even lower weighting. Similarly, loans with an LTV ratio over 95 percent should not be risk weighted higher than unsecured consumer loans. Moreover, subordinate residential mortgages with an LTV ratio above 90 percent do not warrant a higher risk weighting than consumer loans without collateral. The risk weight for multi-family residential mortgages should also be lower than proposed, with relaxed qualification restrictions. And small business loans also deserve lower-than-proposed risk weighting – without qualifications. This holds especially true for those loans that are collateralized by business equipment, property or personal guarantees from high net-worth owners.

No banker indicated to us that some exposures warrant risk weighting over 200 percent, suggesting that there is no current broadly-held exposure that warrants such treatment. ABA recommends that higher risk assets need to be treated on a bank-by-bank basis when detected during supervisory examinations. If, in the future, the Agencies identify a class of exposures that may warrant a risk weight over 200 percent, then they can propose for public comment an amendment to the capital standard.

II.C. Use of External Credit Ratings to Risk Weight Exposures

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 from the ratings treatment as proposed or to use external ratings as a measure for all 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 Agencies seek comment on 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.

The proposed use of external ratings for securities in a bank portfolio, or collateralized or guaranteed exposures, has little meaning for most community banks. Only the very largest banking firms appear to hold meaningful amounts of rated securities, loans to firms that are rated, or exposures that are guaranteed by firms with rated debt. Except for these very large institutions, bank securities portfolios consist almost exclusively of unrated government and mortgage securities. Thus, the external ratings proposal simply does not apply to enough banks to make a difference.

To make the Basel IA option viable for and relevant to a meaningful number of banks, the Agencies need to enlarge materially the recognition of risk mitigants. Bankers use a range of credit enhancements aside from rated debt collateral and guarantees from firms with outstanding rated debt. ABA recommends that collateral that can be legally perfected and objectively and efficiently valued (or marked to market) should be factored into risk weightings – whether or not it is connected with a rating.

For example, where a guarantor's net worth significantly exceeds the guaranteed exposure, the risk weight should be lowered. This type of risk mitigation is commonly encountered in commercial and industrial lending by community banks, such as when a borrower's debt is cross-guaranteed by affiliates of the borrower.

In addition, the collateral value of business equipment and commercial real estate ("CRE") needs to be considered. In essence, the proposed qualification standards for a lower risk weight on small business loans should be relaxed. It makes no sense for collateralized credits to be treated as equivalent in risk to unprotected credits. ***ABA recommends that the Agencies adopt a risk weighting for CRE based on LTV ratios, like the one proposed for residential mortgages.***

While adding these risk mitigants to the rule would increase the reporting burden, it would allow banks to weigh the benefit of lower risk weights against higher costs in data collection and documentation for examiners. This in turn would enable the Agencies to understand banks' risk management practices better and provide greater transparency for supervisory review.

We again suggest that the Agencies validate the risk weights for rated, collateralized and guaranteed exposures and publish the results. Bankers note that charge-offs for investment grade sovereign credit risk are almost non-existent, justifying a near-zero risk weight. One banker noted that what is proposed is similar to the Basel II Standardized Approach (for credit risk), yet slightly more conservative. This observation supports these bankers' call for the Framework's Standardized

Approaches to avoid yet another version of an international capital standard that is rendered less effective by regulatory modifications.

As for the specific proposal, we make the following points:

- The proposal provides that an exposure that is guaranteed by a firm that has outstanding rated debt would be risk-weighted based on that rating. The proposal should make it clear that this implies that if an exposure is to a firm with outstanding rated debt, then the rating of that exposure will similarly determine the risk weighting.
- Currently, exposures to banks or securities firms that are chartered and regulated by a nation in the Organization for Economic Co-operation and Development ("OECD") receive a 20 percent risk weight. The proposal would terminate this treatment, ignoring the stringent federal supervision that these financial institutions receive. ABA recommends that this treatment continue.
- The NPR proposes that corporate securities rated BB+/B-3 or lower would receive higher risk weights than unrated assets. This could have the perverse effect of tempting banks to shed lower rated investments for unrated investments, which could actually raise overall risk profiles.

Question 5: The Agencies are considering whether to use financial strength ratings to determine risk weights for exposures to Government Sponsored Enterprises ("GSEs"), where this type of rating is available, and are seeking comment on how a financial strength rating might be applied… Should the financial strength rating be mapped to the non-sovereign risk weights? Should they apply to all GSE exposures, including short- and long-term debt, mortgage-backed securities, collateral and guarantees? How should exposures to a GSE that lacks a financial strength rating be risk weighted? Are there any requirements in addition to publication and ongoing monitoring that should be incorporated into the definition of an acceptable financial strength rating?

ABA recommends against the use of "Independent Financial Strength" ("IFS") ratings to risk weight exposures issued or guaranteed by a GSE. We believe that the current 20 percent risk weight should be retained.

IFS is not meant for rating the risk to creditors. It was designed to measure the risk of the GSE to the federal government, not the risk of a GSE exposure to a bank. The two are not equivalent.

Moreover, IFS ratings are not ready, at this time, for consideration in a capital standard. As the NPR notes, only some exposures to one GSE have been rated, and that rating would not change the risk weighting. Further, legislation is pending in Congress that could alter how the GSEs do business. When more ratings are available, and GSE reform legislation is resolved, the Agencies can propose a testable system using such ratings.

Question 6: The Agencies also seek comment on whether to exclude certain other externally rated exposures from the ratings treatment as proposed or to use external ratings as a measure for additional externally rated exposures, collateral, and guarantees. Should the proposed ratings treatment be applicable for direct exposures to public sector entities or depository institutions? Likewise, should the proposed ratings treatment be applicable to exposures guaranteed by public sector entities or depository institutions, and to exposures collateralized by debt securities issued by those entities?

Such changes appear to be premature at this time. See our answer to Question 4 above.

II.D. Mortgage Loans Secured by a Lien on a One-to-Four Family Residential Property

Question 7: The Agencies seek comment on all aspects of using LTV to determine the risk weights for first lien mortgages.

We see the elements relating to residential mortgages as an area of promise in the proposal. Nonetheless, we believe that the entire proposed risk weight schedule is too high. For home mortgages with LTV ratios below 60 percent, the proposed 20 percent risk weight is excessive; instead the 10 percent risk weighting that the proposal asks about could be used – but even that is excessive. Based on historic charge-offs, bankers recommend a risk weighting of 5 percent. For home mortgages with LTV ratios over 95 percent, it is incongruous that these be risk weighted at 150 percent – higher than the 100 percent risk weight for other consumer loans that are unsecured. If the Agencies are concerned about underwriting policies for these mortgages, then they should take action through supervisory policies, not through a blanket penalty for all banks.

Perhaps the proposed risk weight scale was set higher to encompass the interest rate risk of these positions. If so, this risk is being double counted, since treatment of rate risk was incorporated into the capital standards in 1995 through supervisory review. Therefore, ***ABA recommends that the risk weight schedule for residential mortgages be lowered to reflect actual experience with credit risk.***

Question 8: The Agencies seek comment on [the proposed] treatment and other methods for risk-weighting privately-issued mortgage-backed securities, including the appropriateness of assigning risk weights … based on the risk weights of the underlying mortgages.

We believe that this approach is acceptable. It will avoid more complicated modeling while still allowing some distinction in risk weighting of various mortgage pools. However, the Agencies and bankers may find better rating methods as more data becomes available. Therefore, ABA does not oppose this provision in the NPR but encourages further review and collaboration with the Agencies on this question, with amendments to the Basel IA rule as appropriate.

Question 9: The Agencies … seek comment on an approach using LTV combined with credit scores for determining risk-based capital [including] 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.

ABA recommends that the Basel IA rule allow banks to risk weight residential mortgages using consumer credit scores in addition to LTV ratios; however, the rule should not* require *the use of credit scores.

Some bankers use credit scores in categorizing and pricing mortgage loans and find this data useful. On the other hand, other bankers have told us that they find credit scores of little relevance in addition to LTV ratios. Either way, very few banks currently compile credit score data to the point that they are prepared to categorize in Call Reports their residential mortgage loans in LTV and credit score buckets. Compiling the added data subject to supervisory review would be a substantial compliance burden for most institutions.

Consequently, ***ABA recommends that the use of credit scores for risk weighting residential mortgages be optional in the Basel IA rule.*** Additionally, for banks that elect to use this variable, the treatment should be similar to that recommended for property values in LTV calculations: users should be required to update the scores only in cash-out refinancings, yet users that choose to update their scores should be allowed to use the most recent data.

ABA also recommends that loan seasoning should be factored into risk weightings for residential mortgage loans – but only for banks that elect to use this variable. Some bankers find this to be an important variable for classifying mortgages and have indicated to ABA that the Basel IA rule should include it. Like the loan amount in the LTV ratio, this variable is easy to compile. However, most users would have to revise their data reporting systems to use it. Thus, optional use of seasoning could improve the Basel IA rule and lead to greater alignment of risk sensitivity with levels of regulatory capital.

Question 10: The Agencies seek comment on whether there are other circumstances under which LTV should be adjusted for risk-weight purposes.

ABA supports the use of LTV values to risk weight residential mortgages, as noted above. While banks do not necessarily have LTV data in their electronic reporting systems at this time, those intending to opt into Basel IA believe that they should be able to integrate this data into their systems within a reasonable time.

As proposed, LTV values would be continually revised for the outstanding balance of loans, since banks can readily verify this data. Nevertheless, to prevent this application from becoming an unwarranted reporting burden, the rule must not require reappraisal of property values except in cash-out refinancings, as proposed. Most mortgage lenders do not continually update these values. The expense to maintain up-to-date values would outweigh the improvement in risk sensitivity for most banks. Additionally, if local economic conditions cause a significant general change in local property values for a bank, then the examiners can adjust required capital, as proposed.

On the other hand, some banks do continually reappraise the collateral for mortgage loans as part of their risk monitoring systems. If these institutions are prepared to support their data to examiners, then they should be allowed to use it for regulatory capital purposes.

Question 11: The Agencies request comment on all aspects of private mortgage insurance ("PMI"), including whether PMI 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.

ABA recommends that the Basel IA rule recognize PMI as a reduction to the numerator in LTV, as proposed. The provider of the PMI coverage should be evaluated as a counterparty risk to

the bank; only in cases where the provider is rated below AA/Aa should something less than the full deduction be authorized.

ABA further recommends that pooled PMI protection count to the same degree as unpooled. As noted at many points in this letter, the Basel IA rule needs to recognize better how banks manage and mitigate risks, and pooled PMI protection is another example of this. A reasonable approach would be to apportion the protection among loans in the pool proportionately with loan balances.

Representatives from several institutions questioned the reason for the proposed differential treatment of PMI providers based on whether the provider is affiliated or not with the bank holding company (but not with the bank). ***ABA recommends that, if supervisors confirm that the protection is provided on an "arms-length" basis, then the risk mitigation should be assessed in the same manner as for an unaffiliated PMI provider.***

Over time, the impact of counterparty risk should be assessed based on actual performance and risk weights should be adjusted accordingly.

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 on 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.

ABA agrees with the NPR's position not to treat mortgages viewed as "non-traditional" with special provisions in the Basel IA rule. As with beauty, non-traditional can be in the eye of the beholder; some new mortgage products are simply combinations of "traditional" products. And a new product that provides something useful for homebuyers should not be arbitrarily discouraged by more conservative capital treatment. Moreover, if the Agencies attempt to draw a bright but arbitrary line between traditional and non-traditional products, then the markets are surely clever enough to work around it. ABA believes that "non-traditional" products are adequately addressed by application of the rules governing mortgages generally.

The proposed treatment of an unfunded negative amortization exposure or a commitment for a reverse mortgage – with a credit conversion factor ("CCF") – is consistent with the treatment of other non-mortgage commitments and appears reasonable.

Question 13: The Agencies request comment on the appropriateness of the proposed risk-based capital treatment for home equity lines of credit ("HELOCs"), including the burden of adjusting LTV as the borrower utilizes the HELOC.

Bankers report that second mortgages and HELOCs, whether the first lien is held or not, differ in performance from first liens, and the former do not impair the latter. Therefore, ABA recommends that first mortgage liens should be risk weighted based on their own LTV ratios, and subordinate liens should be treated separately. Nonetheless, the risk weighting for second mortgages and HELOCs should reflect the secured nature of such exposures.

Accordingly, ***when the bank holds both the first and junior lien (or HELOC) on residential property, these exposures should not be commingled to determine LTV for risk weighting***, as proposed. ***When the bank does not hold the first lien, it is seldom feasible to aggregate the current balance on this lien with the subordinate exposure(s)***, as proposed. This approach would require second lien holders to accumulate data on all liens of equal or higher status, which is seldom feasible. It would be operationally very difficult to maintain current data on all the liens against the property, since a bank cannot be expected to know if the first lien has been refinanced.

As with the proposed risk weighting schedule for first lien residential mortgages, ***ABA recommends that the schedule for subordinate liens should also be shifted down.*** For example, when the aggregate LTV ratio of a subordinate residential mortgage claim is above 90 percent, the proposed risk weight would be 150 percent – higher than that for unsecured consumer loans.

Question 14: The Agencies seek further comment on all aspects of the use of LTV and borrower creditworthiness to determine the risk weight for a junior lien mortgage.

As in our answer to Question 9, ***ABA recommends that banks have the option to use consumer credit scores for risk weighting subordinate mortgages.*** However, most of our bankers would prefer not to use consumer credit scores for mortgages or other consumer loans in risk weightings. This information would require extensive revisions to data management and reporting systems, and the cost would be severely exacerbated if the rule were to require updated data on credit scores. More fundamentally and less measurable, customer management in most community banks is a much better determinant of credit quality than credit scores.

II.E. Short-Term Commitments

Question 15: The Agencies continue to seek comments on an alternative approach that would apply a single CCF of 20 percent to all commitments, both short- and long-term (that are not unconditionally cancelable), and the advantages and disadvantages of such an approach.

ABA supports the application of a capital charge against short-term, noncancelable commitments so that 365 days is not a "bright line" cutoff. We believe that ***a single CCF for noncancelable commitments of all maturities – no higher than 20 percent – would correspond with risk exposure experience.***

II.F. Early Amortizations

Question 16: The Agencies solicit comment on the appropriateness of the 4½ percent excess spread trapping point and on other types and levels of early amortization triggers used in securitizations of revolving exposures that should be considered, especially for HELOC securitizations. The Agencies also seek comment on whether a flat ten percent CCF is a more appropriate capital charge for revolving securitizations with early amortization features.

ABA continues to oppose the imposition of a capital charge against early amortization of revolving credits sold into securitization. First, early amortization is a liquidity risk, not a credit risk, and thus would not be germane for capital requirements against credit risk. Second, institutions with active credit card securitization facilities report that early amortization events are infrequent, so

that any capital assessment is likely to overcharge for the risk. Third, a capital charge would likely make Basel IA securitizers uncompetitive with those on the Advanced Approaches.

However, if the Agencies do adopt such a capital charge, then the excess spread measurement and 4½ percent excess spread trapping point are acceptable to the bankers with whom ABA consulted. None support the flat ten percent CCF. ABA requests that the Agencies estimate and validate the CCF.

II.H. Small Loans to Businesses

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

The NPR largely restates the earlier proposal of a 75 percent risk weight for business loans subject to stringent qualifiers; the loan must:

- be no more than $1 million, and the total exposure to the borrower must be no greater;
- be guaranteed by the borrower's owners and fully collateralized;
- fully amortize within seven years;
- for loans that do not have a fully amortizing schedule (such as operating lines), have a term of no more than 18 months; and
- remain current with a debt service coverage ratio of 1.3 or higher.

Community bankers have extensive experience with excellent quality in their small business loan portfolios. The very low charge-off rates can be attributed to close working relationships between lenders and small business owners. ***ABA believes that this history justifies a lower risk weighting than the current 100 percent for small business loans in general, and requests that the Agencies estimate and validate the risk weight for small business loans.*** Bankers find the proposed 75 percent risk weight acceptable at this time, subject to future validation.

Bankers also find the proposed qualifications for a 75 percent risk weight to be overly restrictive. ABA recommends, as mentioned above, that all business loans that are collateralized with business equipment or property qualify for lower risk weights. We suggest a risk weight schedule for CRE like that proposed for residential mortgages. In particular, CRE loans designated by the bank in the Call Report as "owner-occupied" should be risk-weighted at no more than 75 percent, without a loan size limit. As the recent Agency supervisory guidance on "Concentrations in Commercial Real Estate Lending" recognizes, owner-occupied CRE is different from other CRE.[3] While these loans do not look to the property for repayment but rather to outside sources, they nonetheless remain fully secured by the real estate collateral. As a result, they are quite safe. Many banks report *no* losses on owner-occupied CRE loans over an extensive period of time.

As to the proposed qualifications, ***ABA recommends raising the cap on the size of non-CRE loans to at least $5 million and extending the term limit to ten years.*** Bankers find the proposed $1 million and seven-year cutoff too low relative to the local business firms they finance. The other conditions appear to track factors commonly used by community bankers.

---

[3] See Federal Deposit Insurance Corporation, Federal Reserve Board, and Office of the Comptroller of the Currency, "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices;" 71 Federal Register 74580, Dec. 12, 2006 (a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-9630.pdf).

II.I. Multi-family Residential Mortgages, Other Retail Exposures, Loans 90 Days or More Past Due or In Nonaccrual, and CRE Exposures

Question 18: The Agencies remain interested in industry comments on any methods that would increase the risk sensitivity of the risk-based capital requirements for other retail exposures, particularly through the use of credit assessments, such as the borrower's credit score or ability to service debt. The Agencies are particularly interested in whether and how credit assessments might be applied consistently and uniformly in the determination of risk weights without creating undue burden.

ABA recommends that the risk weighting for multifamily residential mortgage loans should be reduced. Such loans are weighted at 100 percent unless they qualify for 50 percent based on prerequisites for seasoning, amortization, maturity, LTV, and other factors. We believe that the requirements to achieve a 50 percent risk weight are unnecessarily restrictive, and that the 50 percent risk weight is high, based on the low loss experience for such credits. ABA recommends that an LTV ratio of 80 percent or lower should warrant a risk weight of 50 percent or less – without additional qualifications. While this weighting would still be excessive based on bankers' experience, it would not add materially to the reporting burden.

See our answer to Question 17 for suggested treatment of CRE loans.

II.J. The Standardized Approaches

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?

ABA recommends that all banks and banking organizations should be allowed to use the Standardized Approach for credit risk and all of the approaches for operational risk provided for in the international Basel II Framework, including the Basic Indicator, Standardized and Advanced Measurement Approaches.

If the rules from the Framework are used without being materially altered for the U.S. application, then multinational banking organizations will be able to use consistent rules globally. Therefore, they will have working Standardized Approaches systems, which should be acceptable for their U.S. operations.

As explained in ABA's letter on the proposed Basel II Advanced Approaches, a number of banks would prefer to use the Advanced Approaches from the Framework. However, the Agencies have added restrictions and collective conservatism to produce a proposed rule that ineffectively ties capital to risk, would be an expensive and excessive compliance burden, and would put adopting institutions at a competitive disadvantage. In our letter, ABA suggests changes in the proposal to bring it into conformity with the Framework. If the U.S. rule is aligned with the Framework then the banks that would be required to comply with Basel II Advanced Approaches – the "core banking firms" – and a number of potential opt-in organizations will seek to use that system.

However, ***in any event, the Agencies should still allow even core banking firms to use the Standardized Approaches.*** Being less risk sensitive, these Standardized Approaches would likely require more capital than the Advanced Approaches in most cases. In cases where supervisors see a need for additional capital, they can mandate this as per Pillar II in Basel II.

If core banking organizations are allowed to use the Standardized Approaches, as we recommend, this will not, in any way, reduce the supervisory requirements that they develop and maintain state-of-the-art risk monitoring systems to determine capital needs commensurate with their risk profiles. Their business operations, supervisors, and creditors will continue to mandate advanced risk metrics appropriate to the complexity of risk exposures.[4] Therefore, requiring the Advanced Approaches for these institutions is not needed to compel institutions to acquire the capital and risk management systems they need.

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?

As explained in our answer to Question 19, ***the Standardized Approaches from the Framework would be a suitable regulatory capital standard option for all U.S. banking organizations.*** Along with progressively stringent supervisory requirements for risk management commensurate with the complexity of exposures, these approaches would provide a sound supervisory standard for capital and risk management.

ABA recommends that the Agencies adopt the Standardized Approaches without major modification from the Framework. There is no need for a lengthy drafting process, as the work on these standards has been done.

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 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?

The Framework would attach an operational risk component to the risk-based capital requirement for credit risk. The Agencies have proposed not to include an operational risk component for the Basel I or Basel IA approaches, and ABA agrees. However, our conversations with organizations that would consider the Standardized Approaches indicate that they can accept an operational risk

---

[4] Federal Reserve Supervisory Letter SR 99-18 "directs supervisors and examiners to evaluate internal capital management processes to judge whether they meaningfully tie the identification, monitoring, and evaluation of risk to the determination of the institution's capital needs. To support that evaluation, this letter describes the fundamental elements of a sound internal capital adequacy analysis – identifying and measuring all material risks, relating capital to the level of risk, stating explicit capital adequacy goals with respect to risk, and assessing conformity to the institution's stated objectives – as well as the key areas of risk to be encompassed by such analysis." (See Federal Reserve Board letter, "Assessing Capital Adequacy in Relation to Risk at Large Banking Organizations and Others with Complex Risk Profiles," July 1, 1999, page 1, www.federalreserve.gov/BoardDocs/srletters/1999/SR9918.HTM.)

component ***provided that they are allowed to use any of the approaches provided for in the Framework for operational risk.***

Question 22: What additional requirements should the Agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their financial disclosures, if they are provided the option to use alternatives to the Advanced Approaches of the Basel II NPR?

As explained in our answer to Question 19, ***no additional requirements are needed to assure that banking organizations using the Standardized Approaches enhance their risk management practices.*** Federal Reserve Supervisory Letter SR 99-18 and progressive demands of examiners handle this issue thoroughly without any need for mandates embedding in a capital standard.

III. Definition of "Capital"

The Framework does not address the definition of "capital" but the Basel Committee on Banking Supervision has indicated that a review of that definition is contemplated after implementing the Framework. ABA, in its comment on the Basel IA Advance NPR, raised the issue of whether certain contractual rights relating to core deposit intangibles should be included. A fundamental component of the Basel IA approach is recognition of the risk-mitigating benefits of contractual arrangements furnished by investment grade-rated third parties to cover risk exposures. In the case of similar contractual arrangements pertaining to core deposit intangible assets, similar regulatory capital relief should apply. Under current regulatory requirements, identifiable intangible assets associated with purchased core deposits are completely deducted from regulatory capital. Recently however, core deposit acquirers have successfully secured contractual rights from investment grade-rated third parties that guarantee a liquidation value for acquired core deposit bases regardless of future changes in market value. Including core deposit intangible assets whose values are ensured by such contracts in the calculation of core capital would address a potentially serious misallocation of capital requirements with risk exposures.

We believe this would benefit many community banks. Accordingly, we recommend that this change to the definition of "capital" be made as part of the Basel IA rule. We also believe that the Agencies should suggest to the other Framework participants that a comparable change be made to Basel II. If the Agencies determine that the current Basel IA and Basel II rulemakings are not the appropriate vehicles for revising the definition of "capital," ABA recommends that the Agencies revisit the definition in the near future.

IV. Conclusion

ABA appreciates the opportunity to comment on the Basel IA NPR. ABA strongly supports the creation of a menu of capital standards for banks, concluding that a one-size-fits-all approach no longer makes sense given the diversity of the U.S. banking system. ABA believes that the Basel I capital standard should be retained for banks as the default choice. While there are aspects of the Basel IA proposal that are very appealing to some banks – in particular the much more risk-sensitive treatment of 1-to-4 family residential mortgages – many banks tell ABA that they would elect to remain on Basel I.

In fact, it appears at this time that relatively few banks would elect to opt into Basel IA without significant changes to the proposal. Some of those changes should be to:

- reduce the risk weights and/or improve the qualification requirements for residential and commercial mortgages and small business loans;
- expand recognition of collateral and guarantees; and
- allow the option to factor consumer credit scores, loan seasoning, and reappraisals of property value into risk weightings.

Additionally, the NPR discusses possible further changes as the Agencies and banks compile better data on loan performance, an approach we also support. ABA believes that as the Agencies and banks improve risk management systems, these improvements will justify additional modifications in the Basel IA standard that should make it more attractive to banks.

Most larger banking organizations also believe that Basel IA falls short of providing a risk-sensitive capital framework appropriate for their risk management systems. In answer to the question as to whether the Agencies should offer the Basel II Standardized Approaches, many organizations have told ABA that they support such an addition. ABA therefore supports the addition of the Standardized Approaches to the menu of capital standards, and recommends that it should be available to all banks that have the systems in place to support the additional reporting and monitoring required – even the core institutions for the Advanced Approaches. We urge the Agencies to move forward as soon as possible to adopt the Standardized Approaches as internationally agreed to among the members of the Basel Committee on Banking Supervision.

In summary, ABA believes that such a menu approach to capital standards will serve both banks and their supervisory agencies well, with the recommended changes to the Basel IA standard itself and the adoption of the Basel II Standardized Approaches. Given the complexity of the proposal and the number of questions that we have addressed, we invite the staff of the Agencies to contact the undersigned if they have any questions about our comments.

Sincerely,

Paul A. Smith
Senior Counsel

Robert W. Strand
Senior Economist