March 26, 2007

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: No. 2006-49

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
71 FR 77446-518 (December 26, 2006) No. 2006-49

Dear Madam/Sir:

We at Guaranty Bank appreciate the opportunity to comment on the regulatory capital treatment of first and second lien mortgage loans as proposed in the Basel Ia NPR ("NPR"). We share the Agencies' concern over the recent liberalized underwriting environment and the potential risk, not only to originators of and investors in such loans, but also the risk to the borrowers' collective well-being, and the U.S. economy as a whole. In our internal discussions, we draw a distinction between risks inherent in product design and risks in the underwriting process, and it is our hope that the Agencies give careful consideration to the potential for stifling product innovation in any contemplated change in the regulatory capital regime. We also draw a distinction between the function of capital and the function of loss provisioning (through earnings) in our consideration of the "riskiness" of an asset. It is the differentiated perspectives along these two dimensions that serve as the foundation for our comments.

NEGATIVE AMORTIZATION

Regarding mortgage loans with the potential for negative amortization ("neg am"), we acknowledge that the product design itself has the potential to create more "risk" for a portfolio investor. But if "capital" is in place to protect the institution from "unexpected" losses, we struggle trying to understand the difference in "unexpected" losses between an ARM with neg am potential and an otherwise identical ARM that doesn't permit neg am. We think the potential for neg am would be more appropriately captured in the loss

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We think the potential for neg am would be more appropriately captured in the loss provisioning (which captures "expected" losses), and a capital charge against the potential negative amortization would be, effectively, redundant.

We acknowledge that borrowers who choose loan products that permit neg am have a high likelihood of being self-selected users of that neg am feature, and the existence of neg am creates a higher expected loss potential due to reduced equity in the property and the potential for a more pronounced payment shock. However if the Agencies view this as justifying a larger capital allocation linked to unused neg am capacity, we think the methodology should not be identical to that used for unfunded commitments in "corporate" credits. In the event of credit-related adversity, a corporate borrower is likely to draw on his unfunded line, instantaneously, and potentially up to the full amount of the line (though obviously, in the vast majority of instances, draw and paydown activity on corporate lines is not specifically credit-driven). The credit event causes the draw. In contrast, with a neg am mortgage, the "draw" is more incremental, and the full amount of potential neg am is achieved only over an extended period of time, and is not necessarily caused by credit adversity. "Option" ARMs, with the neg am feature, give the borrower month-to-month payment flexibility. There is no reason to assume that the exercise of this flexibility is necessarily a sign of credit stress - for example, in a case where the borrower has a highly variable income which is, on average, sufficient to service the loan. A variable income is a characteristic of the borrower, and should be captured in the underwriting of that borrower, but is not an innate feature of the loan itself. If the borrower chooses the Option ARM because of the low teaser rate, this too should be captured in the underwriting of the borrower, and reflected in the loss provisioning.

If this borrower chose a mortgage with neg am potential, arguably there is no way to know ahead of time what payment pattern he will follow. If he neg ams, that is not necessarily a sign of credit stress. If he doesn't neg am, that doesn't necessarily mean he is free of credit stress. For example, in the latter case, market interest rates may have declined to a point where the loan is positively amortizing at the minimum payment (especially since the spread between the initial rate and the fully-indexed rate is "administered," i.e., doesn't float passively with market rates). There is also the possibility that a borrower will allow for only a limited amount of neg am, and will actively "manage" his cumulative neg am when it reaches some level below the neg am balance cap (of 110% of the original balance, for example) which would otherwise trigger a recast.

We think that, if the Agencies choose to retain a capital requirement for the unfunded portion of the neg am potential, there should be some allowance for a waiving of that requirement, on a loan-by-loan basis, if the borrower has achieved a net reduction in loan balance, at some point in the loan's life, to some percentage of the original face. For example (and this is strictly hypothetical), if at any time after 18 months the current loan balance is no higher than the original balance (i.e., the borrower is making at least the accruing coupon payments), the capital requirement on the unfunded portion could be waived. In addition to, or in place of, this test might be a neg am "incidence" test – for example, as long as the loan balance doesn't rise between any two consecutive months

over the previous six months on a rolling basis, and as long as the loan has never been delinquent, the unfunded capital requirement would be waived. (However a test in any way similar to this latter test might be unduly burdensome for smaller banks, though it could be available on an "opt-in" basis.) If the borrower chooses to incur neg am, additional capital would be automatically held on the increased loan balance, and would capture the change in the LTV. The non-traditional mortgage Guidance has directed that these loans be underwritten at fully-indexed rates, taking into consideration potential neg am. This should be an adequate risk mitigant that is reflected in the loss provisioning.

LTV AND CREDIT SCORE

We wholeheartedly endorse the use of LTV as a means of risk-weighting mortgage assets. LTV contributes to loss provisioning, but we believe it rightfully should influence capital allocation as well since the LTV level influences loan loss volatility for a given level of collateral value volatility. However the risk-weighting scheme using LTV should also capture the realities of the marketplace. Lenders prudently "trade-off" LTV for credit score – a lender will accept a higher LTV if it is compensated for by a higher credit score in underwriting decision-making. We are aware of the obvious implementation difficulties of an LTV / credit score matrix regime. Some of the questions the Agencies would have to address and resolve include: Which credit score ? How "granular" should the buckets be ? What if various LTV / credit score buckets' predictive power migrates (due to refinements to the credit scoring technology) ? Should the buckets be recalibrated through time, including changes to their granularity ? etc..

We think the Agencies should consider implementing an LTV / credit score matrix concept for determining risk-weighting, and allow for future recalibration of the matrix. However if a given mortgage loan is assigned a 35% risk-weighting, for example, because of its position on the LTV / credit score matrix at the time the loan was originated, it might be administratively practical for it to retain that 35% weighting throughout its life even if its original LTV / credit score would assign it a 50% weighting (for example) a year later in a refined matrix.

Regarding updates of LTVs and credit scores, we think it is prudent portfolio management for lenders to update credit scores and LTVs on portfolio holdings over time, with varying degrees of formality and precision (for example, as a practical matter, updated LTVs may not need to be based on full appraisals), and would also capture the effects of both positive and negative loan balance amortization. We urge the Agencies to set guidelines for updating credit scores and LTVs across the entire portfolio, on an opt-in basis, which would result in a potential migration of individual loans to revised risk-weightings. This opt-in could be all-or-none, across the entire portfolio (to prevent "cherry-picking"), and might permit "opting-out" only for extenuating circumstances (for example, for smaller institutions which underestimated the expense burden of a periodic update). In other words, adverse changes in LTV or credit score would result in adverse risk-weighting changes, just as favorable changes in LTV or credit score would result in favorable risk-weighting changes.

Regarding updated LTVs in particular, even if a mass mark-to-market of all collateral (as described in the paragraph immediately above) is not implemented, we request that the Agencies reconsider their current criteria for the use of updated appraisals for risk-weighting purposes. Right now an updated appraisal is used for risk-weighting only if the banking organization extends additional funds (ie, a cash-out refinancing of a loan already in the portfolio, or the taking out of a second lien mortgage on a property with a pre-existing first lien already in the portfolio). We suggest that this treatment be extended to rate/term refinancings of loans already in the portfolio as well. The risk of inflated appraisals is present for all three loan purposes. Additionally we ask that the Agencies consider extending the periodic updating of appraisals to loans that are experiencing neg am, as neg am can be viewed as an extension of additional bank funds.

SECOND LIENS

We petition the Agencies to reconsider the proposed maximum risk-weighting of junior liens - at 150% - in contrast to the maximum 100% risk-weighting on unsecured consumer paper. We have difficulty conceptualizing how a second lien could be fundamentally riskier than an unsecured consumer loan to the same borrower.

We also have trouble reconciling the difference in proposed risk-weighting level, and granularity, between first liens and second liens, based on LTVs for the firsts and CLTVs for the seconds. For example, the suggested risk-weighting for the "60% or less" bucket in firsts is 20%, but in seconds this bucket is 75% risk-weighted. We could understand some difference between the two because of the higher loss "leverage" on the second-lien (ie, loss on the loan relative to loss of collateral value), but this much of a difference "feels" excessive. This same leverage argument would suggest more, not less, granularity in the bucketing scheme for seconds, relative to firsts. Yet the NPR is proposing more granularity for the firsts.

For HELOCs, where the unfunded portion is not unconditionally cancelable, we do not object to the 50% CCF, in contrast to our objection to the 50% CCF for the unfunded portion of neg am loans discussed above, as this appears to be more in line with the potential utilization of unfunded commitments in corporate lines.

Sincerely,
GUARANTY BANK

Jack Falconi
Senior Vice President