March 21, 2007

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551
Re: Docket No. R-1261

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, D.C. 20219
Re: Docket Number 06-09

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Re: RIN 1550-AB56

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20552
Re: No. 2006-33

Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework
71 FR 55830 (Sept. 25, 2006)

Dear Mesdames and Sirs:

America's Community Bankers ("ACB")[1] is pleased to comment on the Risk-Based Capital Standards: Advanced Capital Adequacy Framework Notice of Proposed Rulemaking ("Basel II NPR"), released for public comment on September 29, 2006 by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision ("Agencies"). The proposed U.S. Basel II regulatory capital framework would replace the current Basel I framework for the largest internationally active banking institutions in the United States.

ACB Position

ACB supports the efforts of the Agencies to develop a regulatory capital framework that more closely aligns regulatory capital with risk for the largest internationally active banks in the United States. We believe that a U.S. Basel II will provide these institutions with increased flexibility to determine capital levels and permit the institutions to utilize regulatory capital more

[1] America's Community Bankers is the national trade association committed to shaping the future of banking by being the innovative industry leader strengthening the competitive position of community banks. To learn more about ACB, visit *www.AmericasCommunityBankers.com*.

efficiently and effectively. However, ACB is concerned that the Basel II NPR does not recognize certain market practices and economic measures, the absence of which may reduce risk sensitivity and create perverse incentives for banks. We are also concerned that the Basel II NPR as currently proposed could lead to competitive disparities between U.S. Basel II banks and their foreign counterparts. We recommend that the Agencies harmonize provisions of the proposed Basel II NPR with the International Basel II Accord.

Furthermore, ACB is concerned that the advanced internal ratings-based approach and the advanced measurement approach (collectively, "Advanced Approach") required by the Basel II NPR to calculate credit and operating risk capital, respectively, are too costly, burdensome and complex. We strongly recommend that the Agencies include as an option to the Advanced Approach the standardized approaches for determining credit and operating risk capital ("Standardized Approach") of the International Accord developed by the Basel Committee on Banking Supervision at the Bank for International Settlements ("International Accord"). Adopting the Standardized Approach would help to harmonize the final U.S. Basel II rule with the International Accord and minimize competitive inequalities with foreign banks. Adopting the Standardized Approach would encourage more U.S. banks to opt-in to the U.S. Basel II framework and more accurately align their capital with risk. ACB strongly believes Basel II banks should be able to choose the capital framework within Basel II that best suits the bank's business and risk profile.

Finally, ACB strongly supports the Agencies' retention of a leverage ratio requirement for Basel II banks.

Background

Competitive Concerns

The Basel II NPR framework differs from the International Accord in a number of important provisions. As a result, these differences could give foreign banks a competitive advantage over U.S. banks in both home and foreign markets. Foreign banks under the International Accord will be able to hold less capital than U.S. banks and be able to offer their products and services at a lower cost because of the differences between the proposed Basel II NPR and the International Accord. In addition, until the U.S. Basel II is adopted, U.S. banks will continue to operate under Basel I and will continue to hold more regulatory capital than their foreign counterparts.

Foreign banks under the International Accord may choose among three methods to calculate capital for credit risk and three methods to calculate capital for operating risk. These optional methods include the less complex and less costly to implement Standardized Approach. As a result, foreign banks under the International Accord that adopt the Standardized Approach will be able to hold less costly regulatory capital and use their regulatory capital more efficiently. Utilization of the more risk sensitive capital framework may result in foreign banks being able to offer their products and services at a lower cost than U.S. banks. ACB believes that certain provisions of the Basel II NPR should be harmonized with the International Accord to reduce the competitive disparities.

In order to minimize the competitive inequalities with International Accord banks, ACB believes that the Agencies should proceed with finalizing Basel II and move forward with the transitional periods to implement the capital framework. The transitional period for European banks is to begin in 2007, while the transitional period for U.S. banks is to begin in 2008, but could be further delayed. The European banks will have a one year or more implementation advantage over U.S. Basel II banks. The European banks will also have a shorter two year transition period under the International Accord, while U.S. banks will have a three year transition period under the Basel II NPR. The delays and gaps in implementation put U.S. banks at a competitive disadvantage because the foreign banks will be able to reduce their capital holdings and more effectively use their capital under the International Accord.

Proposed 10% Floor

In response to concerns with the results of the Fourth Quantitative Impact Study, the Agencies included a 10 percent aggregate capital floor in the Basel II NPR. The Basel II NPR provides that a 10 percent decline in aggregate minimum required risk-based capital at Basel II banks would constitute a material reduction necessitating “modifications” to the capital framework.

ACB believes that the 10 percent floor provision should be reconsidered by the Agencies. The 10 percent floor is based on an aggregate percentage decline in capital and therefore applies to all Basel II banks adopting the framework whether or not a Basel II bank experiences such a decline individually. As a result, a 10 percent decline of capital of a few banks could impact the regulatory capital requirements of all Basel II banks and unfairly subject Basel II banks that have not experienced such a decline to the Agency “modifications.” In the Basel II NPR, the Agencies did not define or otherwise elaborate on the “modifications” that the Agencies would require. Furthermore, because U.S. Basel II banks will be in different stages of implementing the capital framework as they transition into compliance with Basel II, capital frameworks will differ and not be comparable or conducive to an aggregate measure.

This provision lacks transparency, will be operationally difficult to apply and creates uncertainty for Basel II banks. Moreover, the intended goal of this provision would be realized through other protections in the Basel II NPR that address capital declines: the transitional floors, the Pillar 2 supervisory controls, and the retention of a leverage ratio. The 10 percent floor is not a requirement in the International Accord and therefore potentially contributes to competitive inequities with foreign banks.

Risk Sensitivity and Distortions

ACB believes that certain provisions of the Basel II NPR distort the risk sensitivity of the capital measures. These distortions do not take into consideration how banks operate and the methods and systems already developed by large banks to align economic capital with risk. Basel II banks should not have to invest in two different methods of capital determination: one based on real-world bank economic needs and one artificially based solely on compliance considerations.

The latter may create perverse incentives for U.S. Basel II banks as described below. Removing these barriers will help increase the accuracy of capital measures and increase risk sensitivity.

Residential Mortgages and the LGD Floor: The Basel II NPR contains a minimum loss given default (LGD) value of 10 percent for residential mortgage exposures. The 10 percent is an arbitrary percentage as well as an artificial floor that may penalize low-risk residential mortgage lending and discourage banks from holding high quality collateral. LGD for mortgage loans will differ based on lien status, delinquency status, borrower credit scores, loan-to-value ratios at inception and at time of default, and private mortgage insurance. Many factors create LGD values lower than 10 percent for residential mortgage loan portfolios. For example, a mortgage loan with a very low loan-to-value (LTV) ratio could result in a lower LGD and a lower capital requirement except for the 10 percent floor. In addition, because of this 10 percent floor, a Basel II bank that maintains a well seasoned loan portfolio with declining LTV ratios from loan amortization over time will unnecessarily be required to hold double or triple the regulatory capital on these loans. This may encourage the bank to hold riskier loans that are at or above the 10 percent floor. ACB believes that the Agencies should re-evaluate this 10 percent floor.

Stressed LGD: The definition of stressed LGD is more conservative in the Basel II NPR than it is in the International Accord. This definition should be reconciled to provide consistency in this important parameter and reduce the disparity between capital requirements.

Under the Basel II NPR, the stressed LGD mapping function does not adequately provide for situations where, due to high credit quality, there are few defaults and LGD in the portfolio and therefore limited stress condition internal loss data. This mapping function penalizes the low probability of default (PD) and LGD measures by placing an arbitrary 8 percent LGD floor for all loans in a portfolio. An expected low LGD will be scaled up so that the stress condition measure is always at least 8 percent. As a result, a fully guaranteed or fully collateralized loan will always have a LGD floor of 8 percent. This creates an incentive for banks to structure loans so that the minimum expected LGD equals 8 percent or greater.

In addition, the Basel II NPR prohibits the use of the mapping function for a small loan portfolio at the same time as direct measurement of LGD is used in another portfolio but within the same Basel II category. A Basel II bank should be permitted to use direct measurement with the mapping function within the Basel II category. For example, a commercial portfolio with few losses has insufficient data for internal measures of stressed LGD. Nevertheless, the Basel II NPR requires that the mapping function be applied to all commercial portfolios in that category in order to prevent "cherry-picking" of approaches. We recommend that the supervisory process of Pillar 2 be used to consider stress in a portfolio to prevent "cherry picking" rather than the conservative approach of the Basel II NPR that sets an arbitrary floor and prevents the use of internal measures where they are the most useful.

Small and Medium Size Business Credit: The Basel II NPR does not include the adjustment for small and medium business lending ("SME") that is included in the International Accord. The absence of this category creates a step function between retail and commercial loan capital categories. This step function is not recognized in the industry. Under the Basel II NPR, retail loans are grouped together and averaged. Commercial loans are rated separately. Without an adjustment for SME, capital requirements could substantially increase as a specific obligor is designated a commercial rather than a retail borrower.

In addition, because the International Accord recognizes this adjustment, international banks may be able to hold less capital than U.S. Basel II banks. As a result of this difference, lending to small business will be more expensive in the United States than abroad and U.S. banks will be at a competitive disadvantage compared to foreign bank affiliates operating in the United States. This could result in a competitive disadvantage for non-Basel II banks competing with foreign bank affiliates in the United States. We recommend that the Agencies include the SME adjustment in the U.S. Basel II to eliminate the step function and to reduce the competitive disparity with foreign banks.

Obligor Ratings for Commercial Real Estate Lending: The Basel II NPR requires that credit exposures be rated for PD and LGD in categories of homogenous credit risk. In the case of commercial real estate loans and multi-family loans, ratings for PD and LGD must represent categories of loans with similar susceptibility to default and LGD. The Basel II NPR also requires that loans to any particular obligor have a common PD and therefore have a linked default status so that when one loan defaults all the loans of the obligor are considered to be in default.

This Basel II provision is not consistent with practices in the industry. Commercial real estate loan agreements often do not contain cross default provisions that would permit foreclosure on multiple properties of the obligor. In addition, laws of local jurisdictions often limit a lender to collecting either on the property or the borrower but not both. It is common in the industry for banks to collect on the property of an obligor in default but not on the obligor. The Basel II NPR requires a bank to treat an obligor's default on one loan as an indicator of default on all other loans held by the bank. There is no evidence as a general matter that an obligor's default on one property is an indicator of default on all other properties of the borrower. The terms of commercial real estate loans vary with the property and may consider, for example, the market and location.

To address this issue, we recommend that the Basel II NPR be revised to permit prioritization of loans defined by certain homogenous risk characteristics. The focus should be on the loan and not on the obligor. The prioritization should recognize variations in cross default provisions within loan agreements and local jurisdiction foreclosure requirements and practices. This prioritization will result in more accurate risk measures and capital requirements.

Definition of Default

The Basel II NPR definitions of default differ from industry practices and the definitions of default in the International Accord. The U.S. definition should be made consistent with the definition in the International Accord. Many models, systems and measures will be based on these definitions. Differing versions of these definitions will create implementation burdens for Basel II banks. The Basel II NPR considers a wholesale obligor to be in default if any wholesale exposure has been placed in a non-accrual status. The International Accord considers an obligor to be in default when the bank determines that the borrower is unlikely to pay its credit obligations in full and the institution is without recourse. In addition, the Basel II NPR provides that a credit related loss of 5 percent or more on the sale of an asset will be treated as a default even if the loan is fully performing. The 5 percent is an arbitrary number that falls within the realm of normal volatility and may lead to false default indications.

As a result, estimates of the risk parameters used to generate the risk based capital requirements are likely to differ between the Basel II NPR and the International Accord. Specifically, estimates of the LGD under the International Accord are likely to be higher than the estimates of LGD under the U.S. Basel II. Also, estimates of PD under the International Accord are likely to be lower than estimates of PD under the U.S. Basel II.

The new definition of default as proposed in the Basel II NPR will require higher capital levels and make capital computations more complex and costly for banks operating in the United States. In addition, many U.S. banks with international operations are concerned that they will have to maintain dual systems, which will increase implementation costs.

Standardized Approach

We strongly recommend that the Agencies adopt the Standardized Approach of the International Accord as an optional capital framework for U.S. banks in the final Basel II rule. ACB has often stated that bank management should be given the flexibility to choose the capital framework that bests suits its bank's size, business and risk assessments. Permitting U.S. banks to choose the Standardized Approach would provide this flexibility and would help narrow the competitive disparity between the U.S. Basel II banks and foreign banks. In addition, we strongly believe that the availability of the Standardized Approach would encourage more U.S. banks to opt-in to the U.S. Basel II and reduce competitive inequities.

The Standardized Approach is set out in detail in the International Accord. The Standardized Approach provides for the calculation of capital requirements based on supervisory determined risk weightings applied to different types of assets. The total exposure to losses from an asset is multiplied by the fixed risk-weight. Similarly to Basel I and proposed Basel IA, the Standardized Approach is less complex than the Advanced Approach but is more finely tuned to differentiate categories of bank risk than Basel I. The Standardized Approach would be less costly and less burdensome for banks to implement because of the predetermined risk-weight categories.

The Standardized Approach also provides bank supervisors with authority and discretion in applying the approach for credit risk in addition to the supervisory review process of Pillar 2. Bank supervisors can adapt provisions of the framework on a bank-by-bank basis to address specific risk concerns. For example:

i) Residential retail exposures are risk-weighted at 35 percent. In applying this risk-weight, the Standardized Approach directs the supervisory authority to ensure that the bank applies the risk weight only for residential purposes and in accordance with strict prudential criteria. Supervisors are directed to increase the standard risk-weight where the criteria have not been met.

ii) Retail exposures that are not past due are risk-weighted at 75 percent if four criteria are met, including sufficient diversification in the portfolio to satisfy the supervisory authority.

The Standardized Approach has been part of the International Accord since inception and has been available for public scrutiny. The Standardized Approach is expected to be implemented, at least initially, by the majority of foreign banks. ACB believes the Agencies should adopt the Standardized Approach in substantially the same form as it appears in the International Accord with only minor revisions to conform to the U.S. banking system. However, ACB strongly believes that the U.S. version of the Standardized Approach should be subject to the retention of a leverage ratio as is the Advanced Approach under the U.S. Basel II framework. Adoption of the Standardized Approach in this manner should not significantly delay the procedures for finalizing the Basel II NPR.

Leverage Ratio

ACB supports the retention of a leverage ratio requirement, whether that requirement stays the same or the Agencies adjust the level of the ratio or its components for institutions that are well or adequately capitalized under prompt corrective action regulations. Internal ratings based systems are not yet fully tested and there are no satisfactory methods in place to adequately measure all risks that banks face. Therefore, complete reliance should not be placed on the results of economic capital calculations for the purpose of computing minimum regulatory capital requirements. A leverage ratio will help ensure that there is a base level of capital available to the institution during stressed conditions.

Disclosure Requirements

ACB believes that the Basel II NPR Pillar 3 disclosure requirements are overly prescriptive and burdensome. We also believe that the amount of detailed information that is required to be disclosed could lead to disclosure of proprietary information. For example, disclosures are based on an average of loans in a particular portfolio category. Banks with few products within a category will risk divulging specific information about their loans. In addition, the requirement to report risk parameter estimates in comparison to actual outcomes may result in misleading disclosures. As written, point-in-time results could be mixed with long-term averages or through-the-cycle risk measures. ACB recommends that the reporting requirements be revised to reduce the level of portfolio granularity and provide flexibility for Basel II banks to determine the time horizon for comparison of model results and actual outcomes.

Conclusion

ACB appreciates this opportunity to comment on the Basel II NPR. Regulatory capital requirements are an important issue for community banks. Although we support a regulatory capital framework that more closely aligns bank capital with risk, we continue to be concerned with the competitive impact of the Basel II NPR on U.S. Basel II banks competing with foreign banks and U.S. Basel II banks competing with non-Basel II banks. To minimize the competitive disparities, we urge the Agencies to move forward with finalizing the Basel II NPR and the Basel IA NPR, taking into account public comments from the industry.

If you have any questions, please contact the undersigned at (202) 857-5088 or via email at rdavis@acbankers.org or Sharon Haeger at (202) 857-3186 or via email at shaeger@acbankers.org.

Sincerely,

Robert R. Davis

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