ZIONS BANCORPORATION

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March 26, 2007

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Board of Governors of the
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Regulation Comments
Chief Counsel's Office
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Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
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Re: Risk-Based Capital Standards: Advanced Capital Adequacy Framework; 71 Federal Register 55830; September 25, 2006; FDIC RIN 1550-AB56, FRB Docket No. R-1261, OCC Docket No. 06-09, OTS Docket No. 2006-33

Ladies and Gentlemen:

This letter conveys the comments of Zions Bancorporation on the proposed implementation in the United States of bank capital regulations commonly known as Basel II and Basel Ia. We intentionally do not address the specific questions posed in the NPR, because we believe that at this stage those questions miss the main issue. That issue is the totally disparate regulatory treatment of capital (1) within the United States between banks operating under the Basel II regime vis-à-vis banks operating under the Basel Ia, and (2) between United States banks operating under either regime and banks in other countries, particularly EU countries, operating under Basel II but implemented in a radically different way. These disparities result in the same loan requiring different levels of capital not dependent on the economic risk of the loan, but rather dependent solely on the regulatory regime under which the lending bank headquarters operates. This is totally counter to one of the original objectives of Basel II, creating a level capital playing field worldwide.

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These disparities in capital regime will result generally in:

- EU banks being strongly advantaged vis-à-vis US banks for the same loan to the same borrower, even when lending to identical US borrowers within the US[1];
- Very large US Basel II banks being strongly advantaged within the US vis-à-vis small US banks, for the same loan to the same borrower;
- Multi-line banks being strongly advantaged within the US vis-à-vis monoline banks focused primarily on low-risk lending, for the same loan to the same borrower.

Due to these disparities, we predict that these regulations will lead to:

- Disappearance of low-risk "monoline" companies, such as banks focused on low-risk, high-quality home mortgage lending. These monoline companies will be forced solely by capital regulation to INCREASE THEIR RISK by diversifying into riskier lending. Paradoxically, high risk monoline companies will be able to operate comfortably;
- Further consolidation of the US banking industry as smaller banks, unable to earn a competitive return on their regulatory-required capital, are forced to sell to larger banks;
- Further expansion of EU and other foreign banks in the US, as their more favorable capital regulation allows them to earn a higher return on capital lending in the US than in their home country, and in a higher return than a US bank making the same loan.

Three key decisions made by US regulators will lead inevitably to these results. Unless these decisions are reversed, no amount of tinkering with the specifics of the capital regulations will change materially the disparities and outcomes described above. These three key decisions are:

- Banning the "Standardized Approach" to Basel II: Basel II, as agreed to by the banking regulators of all major countries, envisioned both a "standardized" approach and an "advanced" approach to the implementation of Basel II. The standardized approach would convey many, but not all, benefits of the full advanced approach, but be simpler and less costly to implement. It was envisioned as an interim objective to facilitate the transition of banks from less sophisticated risk management systems to the extremely costly, sophisticated and rigorous advanced approach. US regulators early on decided not to allow the standardized approach for any US banks, while EU regulators allow it. This makes it prohibitively expensive for any but the very largest US banks to adopt Basel II in any form.

[1] We note that many foreign banks have more advantageous accounting and tax structures that convey further advantages, particularly in the context of the acquisition of a bank in the U. S. Perhaps most important is the ability to write-off goodwill, and deduct this expense for tax purposes, while U. S. banks cannot expense goodwill unless value is impaired, must hold dollar-for-dollar capital against goodwill, and if an impairment write-down is taken, may not deduct this charge for tax purposes. However, since this comment letter is primarily about Basel II and Basel Ia, we do not elaborate further on these important issues here.

- Keeping the "leverage constraint": US regulators are not allowing the full implementation of even the advanced approach in the US. Pressured primarily by the FDIC, US regulators are leaving in place a vestige of older capital regulation, called the "leverage constraint." Simply put, the leverage constraint says that no matter what mix of business a US bank does, no matter how low risk that business really is, it must keep at least 5% capital in relation to its total assets. EU and other foreign banks are not subject to the leverage constraint, even within the US. Below we illustrate why this disparity is critical.
- Making Basel Ia "rules based": In an attempt to make up for the disparities caused by the first two decisions above, US regulators have proposed a "Basel Ia" capital standard. Basel Ia in essence is a detailed, inflexible "rules based" prescription of capital levels for a variety of loan types. Although apparently intended to convey some of the capital advantages of Basel II for some loan types, it clearly rejects conveying those advantages for other loan types. These decisions are based on subjective biases of the US regulatory agencies, not on any data-driven results of any of the Quantitative Impact Studies ("QIS") undertaken by large US banks at the behest of the regulators. In addition, the proposed Basel Ia standard does not eliminate the leverage constraint, and so preserves disparities created by that decision.

There already is ample evidence of the impact of theses disparities; for example:

- WaMu, a well managed, low risk organization with a primary focus on high quality mortgage lending, has in the last couple of years made acquisitions that diversify its assets into lower quality consumer credit cards (Providian) and higher risk commercial real estate finance (Commercial Capital Bancorp) in Southern California. The authors believe that this is a clear example of a mandatory Basel II, but low-risk monoline, lender diversifying into higher risk activities due to the retention of the leverage ratio;
- Countrywide Financial, another highly regarded residential mortgage lender has announced that it will switch Countrywide Bank from a bank to a thrift charter under OTS supervision. Since Countrywide Bank was only created in 2001, it appears that their management team concluded that very recent trends in regulatory capital proposals, most notably Basel II, would be disadvantageous. Under the OTS, there is no need for them to adopt Basel II.
- BBVA, a leading international bank based in Spain, but with major presence in Latin America, is now aggressively expanding into the United States through acquisitions. It is competitively capital, tax, and accounting advantaged and therefore able to pay higher prices than US banks for these acquisitions. One example is its operating leverage/capital advantage. Since BBVA and many large foreign banks operate with consolidated tangible common equity levels that are 30-50% lower than the largest US banks, and about 40-60% lower than US regional banks, they can offer loans that are priced significantly lower than the largest US banks, and even lower pricing versus smaller US regional and US community banks.

The only way to overcome these issues is to reverse the three key misguided decisions made by US regulators in implementing Basel II differently than it is being implemented in any other country:

- Allow US banks to use the standardized approach to adopt Basel II;
- Eliminate the leverage capital constraint;
- Totally change the rules based approach to Basel Ia; instead tie Basel Ia capital levels by asset class to the average of the economic capital calculated by the mandatory Basel II banks for the same asset class. We outlined this approach in our previous comment letter on the ANPR, dated January 18, 2006.

As a simple illustration of the powerful market effects of the Basel proposals, we provide a simple loan pricing example. Suppose that five banks, all with 5% or higher total bank leverage ratios, allocate five different capital ratio levels to a conventional commercial loan. These five differing ratios result from differences in either internal Basel II models and/or the rules-based Basel Ia method. (In this example, it is assumed that a bank can allocate as low as 2.5% capital to commercial loans, since it could make up the shortfall for its total bank leverage ratio either by allocating more than 5% capital to other loan types and/or through allocations of capital for operations risk.)

For all banks, we assume that the required return on capital is 12%, the marginal tax rate is 40%, and the average expense rate for originating and servicing loans is 1.0%. We have adopted these simple assumptions to spotlight the effects of differing capital allocations on required loan spreads.

Loan Pricing Example:	
Cost of Capital:	12%
Tax rate:	40%
Expense rate:	1.00%

Capital ratio:	Required Breakeven Spread[1]:
2.5%	1.50%
4.0%	1.80%
5.0%	2.00%
6.0%	2.20%
8.0%	2.60%

[1]Pricing Spread which covers Cost of Capital

There is a wide disparity in loan spreads over cost of funds required to provide a 12% return on capital from a low of 1.50% to a high of 2.60%. Such differences would logically provide significant competitive advantages for the banks at the low end of the capital range. Over

time, it is reasonable to expect that those banks would gain market share and the disadvantaged banks would lose share. Based on our observations, Basel Ia banks would be at the high end of the range and international banks would be at the low end.

We now turn to a highly simplified merger and acquisition example. In this example, a foreign bank, with a higher leverage, has a significant advantage over a domestic bank in acquiring another U. S. bank, simply due to more favorable capital regulation:

Pre-Acquisition characteristics of Acquired U. S. Bank:
Assets: $5 billion
Capital $250 million (5% of assets)
Earnings of acquired U. S. bank: $50 million
Operating costs: $120 million
Tax rate: 40%

Cost savings in acquisition: 40% of pre-merger expenses

Foreign Acquiring Bank:
Target rate of return: 12% after tax
Earnings after expense reductions: $69 million
Effective tangible equity ratio required by home country: 3%
Acquisition price: $675 million
Tangible capital required: $150 million
Excess capital withdrawn post acquisition: $100 million
Effective capital employed: $575 million at a 12% return

U. S. Domestic Acquiring Bank:
Target rate of return: 12% after tax
Earnings after expense reductions: $69 million
Effective tangible equity ratio required by home country: 5%
Acquisition price: $575 million
Tangible capital required: $250 million
Excess capital withdrawn post acquisition: zero
Effective capital employed: $575 million at a 12% return

In this highly simplified example the foreign bank can pay $100 million more for the same U. S. bank than can a domestic acquirer, even with the same cost savings, and same return on investment goals. This bidding advantage arises solely from the disparate capital requirements, and ignores the additional tax savings and other advantages derived by the foreign acquirer from the write-off and tax deductibility of goodwill. These advantages are not just hypothetical; the authors believe that foreign buyers recently involved in major acquisition of U. S. banks are well aware of and utilize these advantages.

In summary, the management of Zions Bancorporation urges the regulatory agencies to reconsider the adverse implications of (i) banning the standardized approach for U.S. banks, (ii) keeping a leverage constraint when measuring economic risk capital, and (iii) adopting a rules-based approach to Basel 1a. It seems ironic that, in the name of reflecting economic risk differences, the current regulatory capital proposals will result in greater disparities among international, large domestic, smaller domestic, and monoline banks in ways that do not reflect economic risk differences.

Very truly yours,

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Vice Chairman and Chief Financial Officer
Zions Bancorporation