November 3, 2005

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G St., N.W.
Washington, DC 20552

Attention No. 2005-40

Dear OTS:

I wish to comment on the Advance Notice of Proposed Rulemaking relative to Risk-Based Capital Guidelines. Whether or not Alaska Pacific Bank, as a publicly held small community bank with only five branches, would be at a competitive disadvantage because of the proposed changes is uncertain. However, the changes potentially introduce a complexity which would require not only additional time and expense to administer, but also potentially very expensive IT upgrades for gathering the data on an ongoing basis for all the different types of loans covered by the proposed rules.

Our bank is a former mutual savings and loan that converted to a stock corporation while retaining its thrift charter, regulated by the OTS. We have made a strategic shift from residential mortgage lending to commercial lending, but still provide quite a selection of first mortgage and home equity products in addition to non-real estate consumer loans. We do not have a credit card portfolio, so we will not comment on the *Section K. (Early Amortization)* of the proposed rules.

Here are our detailed comments, section by section:

A. *Increase the Number of Risk-Weight Categories*:

   In looking at the additional categories, it seems that the lowest percent at 20%, defines the lowest of the additional risk weights at 35%, the midpoint between 20% and 50%. We believe the lowest percent should be lowered to 15%, or even 10%, to provide for a larger interval between the lowest percent and the next highest (50%). The second lowest percent would more meaningfully be either 20% or 25%.

   The highest percent (new), at 350%, seems excessive, as it is nearly twice the highest percent (old) of 200%. It would have seemed more natural mathematically to add as the new highest percent a 250% risk weight.

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B. Use of External Credit Ratings:

Having worked for both large and small banks, I can see the applicability of external credit ratings as guidelines for large corporate banks. However, in our small bank, we have only one credit exposure to a publicly rated company, and it is a very small (0.31%) participation in a $550 mln credit facility. My reaction to the gradations of risk weights is that BBB/BBB- are being unduly penalized, since all companies that are rated in those two buckets are still investment grade, and thus we should not have a doubling of the risk weight (from 50% to 100%) within the BBB range. I would think that C-rated, not B-rated, credits would be at the 350% level, and BB split into 100%, 150%, and 200%.

C. Expand Recognized Financial Collateral and Guarantors:

i. Recognized Financial Collateral: Our small bank ordinarily does not make loans collateralized by corporate securities, but I pose the question back to the regulatory panel of how to assign a risk weight to loans secured by mutual funds, with a variety of companies and risks, some of which may not be investment grade. Until there is a methodology on risk rating mutual funds (which there may be, but certainly not well known by community banks), this rule would only solve a small part of the problem.

ii. Eligible Guarantors: The rule-making is predominantly aimed at governmental entities, including foreign governments. Most community banks do not make loans to foreign entities or to borrowers guaranteed by foreign entities. Guarantees by substantial individuals for commercial loans support a major part of our credit portfolio, and, as discussed below, the strength of the guarantors, be it assessed by credit scores, financial ratios, or absolute level of net worth, should be reflected in the risk weights.

D. One-to-Four Family Mortgages: First and Second Liens:

We strongly support the notion of LTV tiering for risk weights but suggest that there should be equal emphasis on borrower strength, as most problem loans do not lead to repossession and loss, but simply added management time, expense, and monitoring. PMI should mitigate 100% of this risk, so long as the PMI company is rated A or better, as the rule suggests. In the event of a national real estate "meltdown," affecting the entire PMI industry, there would be no real reason to distinguish between "good" and "bad" loans, as real estate across the nation would be significantly reduced in value. However, most "meltdowns" occur regionally or in specific urban areas (e.g. the energy shock of the mid-80's), and thus the problem would be remote for those institutions which are national or even super-regional. In the case of Alaska, or the Juneau market to be specific, a

move of the state capital out of Juneau, for instance, would have disastrous consequences for the local real estate market, and even lower LTV properties (say 70%-80%), which do not require PMI would be affected. A risk-weight floor for PMI mortgages could probably be 50% or slightly lower.

As for the frequency of updating LTV's, it would be difficult to conduct an annual review of an entire residential mortgage portfolio for resetting capital levels; however, to the extent automatic LTV data updates (based on outstandings) could interface with and reset portfolio risk buckets, the process would be worth it. Again, as noted above, expensive IT upgrades might make it difficult for community banks to comply with this rule in the short term.

E. *Multifamily Residential Mortgages:*

At our bank we treat most multifamily exposures as commercial real estate risk, and thus do not object to 100% risk weight. However, we agree with the logic that a seasoned loan might carry a lower risk weight, and 50% seems appropriate. Most apartment loans have 10-year maturities with balloons and thus carry substantial refinancing risk, especially when deferred maintenance and demographic issues are included. Then, too, with much greater home ownership across the country as a result of more first-time buyer programs at GSE's and other agencies (such as Alaska Housing Finance Corp.), the rental market has slacked off, and economics for apartments in general are not as robust as they were several years ago. We agree that payment history, seasoning of the loans, and LTV are probably good proxies for risk and easier to monitor than intangible or subjective factors like "condition" and "neighborhood," even though appraisers usually assign values to them for sales comparison adjustments.

F. *Other Retail Exposures:*

Although some credit scoring methodologies have come under criticism recently, we agree strongly that they should be "matrixed in" to determine risk weights for setting capital. Debt-to-income ratios, while helpful, are not going to be dispositive in the case of retired persons or wealthy individuals who do not need to work. Frequently there are different opinions within institutions about how to calculate "normalized" income for self-employed persons, and it is often especially difficult to calculate disposable income available for debt service for people with high fixed payments for categories such as alimony, medical expenses, self-insurance, and the like.

G. *Short-Term Commitments:*

We believe that there is not enough difference between short-term and long-term commitments justifying a 50%-10% split. Most of our unfunded commitments are for construction loans or working capital lines of credit, which expire in less than one year, and we do not object to applying a 20% weight across all such

commitments. However, to the extent a commitment is truly "long-term" (i.e. greater than 5 years), which is rare in our business, a 50% weight might be appropriate. For instance, I recall from years past that standby letters of credit (financial commitments) carried the full 8% capital (or solvency, as it is called at some banks), whereas short-term commercial paper backup commitments carried 4%.

H. Loans 90 Days or More Past Due or in Nonaccrual:

The proposed rules do not suggest a specific percent. However, as stated above, it is hard to imagine a reason to assign a weight higher than 250% unless the exposures are not fully covered by reserves. In that case, a bank has a more serious systemic problem than risk weighting its capital and probably has a flawed Reserve for Loan Losses process.

I. Commercial Real Estate Exposures:

We believe that assigning a weight higher than 100% to commercial real estate loans, even ADC loans, is not appropriate, especially when such loans are mitigated by high reserves. Our standard for reserves is 10%, but, indeed, many substantial borrowers have much greater reserves, though they may not be in the form of liquid assets. We would agree with a standard of 15% for borrowers without multiple projects, or whose projects are all in one sub-market, such as a single suburb or smaller community. We would also suggest to the agencies that they set standards for leases and credit tenants to keep the risk weight rather low, especially when the tenant is the US government or one of similar strength, in the context of the size and complexity of the project. We would also suggest that mixed use projects carry lower risk weights than single use projects, though this criterion would not be as important as the quality of lessees or the percentage of presold or preleased units within the projects.

J. Small Business Loans:

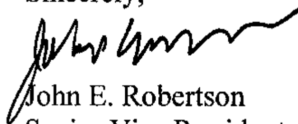
For community banks, the $1 million consolidated threshold for borrowers may be too high. Alaska Pacific Bank has only 29 borrowers with total exposure greater than $1 million. $750,000 might be a better threshold, or perhaps having three thresholds at 100% (>$1mln), 75% ($750,000-$1mln), and 50% (<$750,000). Again, our rationale is that borrower characteristics are generally more important than the underlying collateral, but agree that terms under 7 years should carry lower risk weights. Credit should also be given for the length of time the borrower has had a credit relationship with the bank, and borrower's overall payment history over that time, including, if possible, periods of economic stress.

That concludes our comments. The changes seem so sweeping that it will be difficult, once they're agreed, to implement in a single expeditious process. In general, our main preferences would be:

- Greater use of borrower/guarantor (as opposed to collateral) criteria in determining risk weights (by credit scores, history, relationship, net worth, etc.)
- More distinction in commercial real estate between types (or purpose) of projects: i.e. mixed use vs. single use, retail vs. residential, office vs. industrial, etc.
- Use of more matrices (such as the proposed LTV matrix) than narrative, legalistic rules which are frequently hard (even for senior credit officers) to understand or apply
- Not penalizing an institution to the extent of a 350% risk weight for problem credits, especially those which have good underlying collateral, are in good industries/geographies, or have substantial borrowers who may be undergoing temporary stress

Thank you for the opportunity to submit our comments. We look forward to the outcome of the rule-making process.

Sincerely,



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