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January 17, 2006

Office of the Comptroller of the Currency  
250 E Street, SW  
Mail Stop 1-5  
Washington, DC 20219  
ATTN: Docket No. 05-16

Ms. Jennifer J. Johnson, Secretary  
Board of Governors  
of the Federal Reserve System  
20th Street and Constitution Avenue, NW  
Washington, DC 20551  
ATTN: Docket No. R-1238

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

Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G Street, NW  
Washington, DC 20552  
Attention: No. 2005-40

**Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines;  
Capital Maintenance: Domestic Capital Modifications**

Ladies and Gentlemen:

The Charles Schwab Corporation ("Schwab")<sup>1</sup> appreciates the opportunity to comment on the Advance Notice of Proposed Rulemaking ("ANPR") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (together, the "Agencies") regarding proposed revisions to the Agencies' existing domestic risk-based capital rules.

Schwab agrees with the Agencies that it is important to update their risk-based capital standards to enhance the risk sensitivity of the capital charges, to reflect changes in accounting standards and financial markets, and to address competitive equity questions

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<sup>1</sup> The Charles Schwab Corporation is one of the nation's largest financial services firms. Through our subsidiaries - including Charles Schwab & Co., Inc., Charles Schwab Bank N.A., U.S. Trust Corporation and CyberTrader, Inc. - we provide securities brokerage, banking, wealth management and related financial services for over 7 million active accounts with more than \$1 trillion in assets. The Charles Schwab Corporation is one of the nation's top 35 Bank Holding Companies with total assets in excess of \$45 billion.

that, ultimately, may be raised by implementation of the New Basel Capital Accord ("Basel II") by the largest U.S. banks.

This letter responds to the Agencies' request in the ANPR for comment on possible modifications to their risk-based capital standards that would facilitate the development of fuller and more comprehensive proposals applicable to a range of banking organization activities and exposures. Schwab wishes to express its appreciation for the Agencies solicitation of broad based comments and suggestions and we have endeavored to respond accordingly.

### **Use of External Credit Ratings**

*P. 9 To enhance the risk sensitivity of the risk-based capital framework, the Agencies are considering a broader use of NRSRO credit ratings to determine the risk-based capital charge for most NRSRO-rated exposures. If an exposure has multiple NRSRO ratings and these ratings differ, the credit exposure could be assigned to the risk weight applicable to the lowest NRSRO rating.*

*P. 10 The Agencies solicit comment on (1) whether the risk-weight categories for NRSRO ratings are appropriately risk sensitive, (2) the amount of any additional burden that this approach might generate, especially for community banking organizations, in comparison with the benefit that such organizations would derive, (3) the use of other methodologies that might be reasonably employed to assign risk weights for rated exposures, and (4) methodologies that might be used to assign risk weights to unrated exposures.*

We agree with the methodology of using credit ratings to determine the risk-based capital charge for most NRSRO<sup>2</sup>-rated exposures. However, we believe the suggested weightings are not appropriately risk sensitive. For example, requiring a 75% risk weight for a loan well secured by pool of BBB collateral is severe relative to the average loss rates experienced by BBB rated bonds. A recent study by one of the NRSRO's<sup>3</sup> found that one-year average credit loss rates for BBB bonds from 1982 to 2004 were 0.13%. Certainly, loss rates increase with a longer time horizon but the same study showed that average cumulative loss rates for BBB bonds even over a three-year time horizon remained just below 1%.

The same study referenced above showed that the one-year loss rates on BB rated bonds averaged just 0.77%. In light of that loss history, we believe the proposed 200% risk weight for a loan secured by a pool of BB rated bonds is too high. Since unsecured loans currently have a 100% risk weight, it appears banks would be penalized for collateralizing an

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<sup>2</sup> Credit ratings that are publicly issued by Nationally Recognized Statistical Rating Organizations (NRSROs).

<sup>3</sup> More specific details of the NRSRO study are protected by copyright. Schwab would be happy to provide a reference to the Agencies to obtain more detailed information on historic default and recovery rates for NRSRO rated securities.

otherwise unsecured loan with a diversified pool of BB rated assets, despite the fact that the collateral pool would have a historic one year loss rate of less than 1%. We believe the suggested risk weights for NRSRO-rated exposures should be reduced to better reflect the historic loss rates of those exposures.

**Expand Recognized Financial Collateral and Guarantors**

i. Recognized Financial Collateral

*P. 11 The banking industry has commented that the Agencies should recognize the risk mitigation provided by a broader array of collateral types for purposes of determining a banking organization's risk-based capital requirements. The Agencies believe that recognizing additional risk mitigation techniques would increase the risk sensitivity of their risk-based capital standards in a manner generally consistent with market practice and would provide greater incentives for better credit risk management practices.*

We strongly support the expansion of recognized collateral to include short- and long-term debt securities as outlined in the ANPR. However, we believe a further extension of recognized collateral to include equity-type securities is necessary<sup>4</sup>.

The Charles Schwab Corporation, through its retail banking, trust company, and broker-dealer subsidiaries has substantial experience in loans collateralized by marketable securities (including current balances in excess of \$11 billion). In our experience, given appropriate credit risk management, net losses on loans collateralized by marketable securities are extremely low. Schwab is prepared to share with the Agencies, in a non-public forum, details of our historical loss experience across all affiliates associated with such lending.

Under Basel I, loans collateralized by equity-type securities require a 100% risk weighting. As the ANPR does not explicitly address such loans, we assume a 100% risk weighting would continue under the proposed rule. Based on our substantial experience with lending of this type, a 100% risk weighting is unjustifiably high. Failure to address this issue will result in material distortions in the amount of regulatory risk-based capital required for large and small institutions as the former may use the extremely low loss history to substantiate far lower capital requirements under Basel II. We believe this could create inappropriate incentives for smaller banking organizations to pursue higher risk / higher yielding assets that can adequately support the 100% capital requirement.

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<sup>4</sup> Equity-type securities could be defined as all qualified Investment Company Act of 1940 (1940 Act) Mutual Funds as well as exchange traded stock, funds (ETF's, etc.), and American Depository Receipts (ADR). The practice of limiting the acceptable securities to those that are exchange traded benefits from the regulated exchanges' active delisting of companies that do not meet minimum levels of disclosure (and more specifically excludes all Bulletin Board and "Pink Sheet" traded securities).

There are undoubtedly many ways to assign risk-weightings to loans secured by marketable securities. We have provided two suggested methods below. The first, our preference, uses firm specific loss history to assign risk weightings using a portfolio approach<sup>5</sup>. The second uses a loan-by-loan matrix method similar to that suggested in the ANPR for mortgage loans.

**Portfolio approach:** In the section on “Qualifying Revolving Exposures” (QREs) in Basel II, the Agencies acknowledge the usefulness of a portfolio approach for establishing capital requirements for homogenous pools of loans. Similarly, there is a well-established industry practice of determining loan loss reserves based in part on the performance of homogenous pools.

With the addition of some simple qualifying requirements, such as minimum loan-to-value (LTV) levels, broad qualifying collateral requirements, and portfolio diversification minimums, we believe a portfolio approach would work well for loans secured by marketable securities. In addition, basing such an approach on the loss history of the firm would have the added benefit of implicitly encouraging the type of strong credit risk management practices that result in lower losses.

**Portfolio approach example criteria:**

- Loans in the pool must have an LTV of 80% or less and be similarly underwritten. The portion of any loan exceeding an 80% LTV would be subject to the risk weighting of the borrower or guarantor.
- Collateral may consist of NRSRO investment grade rated fixed income securities and exchange traded equity-type securities (*defined above*).
- To ensure diversification, the largest single loan in such pools must represent no more than 2% of the pool. Amounts greater than 2% that otherwise qualify for inclusion require the greater of the risk weight for the pool or a 50% risk weighting.
- Pledged collateral must be: marked to market each day, subject to daily margin maintenance requirements, subject to the firm’s physical possession or control, and able to be liquidated promptly by the banking organization without intervention by another party.
- Loss history is based on the greater of the most recent rolling four quarters (1 year) or the prior twelve quarters (3 years).

<b>Avg. Net Loss History</b>	<b>Risk Weight</b>
> 0.50%	100%
> 0.35% but ≤ 0.50%	50%
> 0.20% but ≤ 0.35%	35%
≤ 0.20%	20%

<sup>5</sup> For reference: The SEC has determined that in order to have consistency with the proposed Basel Standards for determining the appropriate amount of capital, that such loans held by Supervised Investment Bank Holding Companies (SIBHC’s) “could be treated as a pool with very low loss history” and that “the SIBHC could use internal estimates of exposure at default that take into account the loss history for the pool.” (Federal Register / Vol. 69, No. 118 / Monday, June 21, 2004 / Rules and Regulations / Page 34483)

**Loan Matrix Approach:** In the ANPR section on one-to-four family mortgages, the Agencies suggest basing risk weights on LTVs as a means of improving the risk sensitivity of the existing risk-based capital framework. Similarly, LTVs could be used to establish risk weights for loans secured by marketable securities. We believe such a method is well supported by the historically low losses in this asset class and with the addition of some broad qualifying collateral requirements would improve the risk sensitivity of the existing risk-based capital framework.

**Loan specific matrix example criteria:**

For example:

- Collateral may consist of NRSRO investment grade rated fixed income securities and exchange traded equity-type securities (*defined above*).
- Pledged collateral must be: marked to market each day, subject to daily margin maintenance requirements, subject to the firm's physical possession or control, and able to be liquidated promptly by the banking organization without intervention by another party.

LTV Percentage	Risk Weight
> 90%	100%
> 80% but ≤ 90%	50%
> 70% but ≤ 80%	35%
≤ 70%	20%

**One-to-Four Family Mortgages: First and Second Liens**

*P. 12 Under the existing rules, most one-to-four family mortgages that are first liens are generally eligible for a 50% risk weight. Industry participants have, for some time, asserted that this 50% risk weight imposes an excessive risk-based capital requirement for many of these exposures. The Agencies observe that this "one size fits all" approach to risk-based capital may not assess suitable levels of capital for either low or high risk mortgage loans. Therefore, to align risk-based capital requirements more closely with risk, the Agencies are considering possible options for changing their risk-based capital requirements for first lien one-to-four family residential mortgages.*

*Several industry participants have suggested that capital requirements for first lien one-to-four family mortgages could be based on collateral through the use of the loan-to-value ratio (LTV). Basing risk weights on LTVs in a manner similar to that illustrated is intended to improve the risk sensitivity of the existing risk-based capital framework. The Agencies believe that the use of LTV ratios to measure risk sensitivity would not increase regulatory burden for banking organizations since this data is readily available and is often utilized in the loan approval process and in managing mortgage portfolios.*

We strongly support the Agencies' proposal to revise the risk-weighting approach on one-to-four family residential mortgage loan portfolios. The Agencies are correct in observing that the current "one size fits all" approach does not appropriately distinguish low-risk from high-risk mortgage loans. We also strongly support the Agencies' proposal to utilize LTV ratios as a measurement of risk. The LTV ratio is a good measure of risk sensitivity as it suggests the severity of the loss that the Bank would actually suffer in the event of borrower default. The Agencies are also correct in believing that using LTV would not increase regulatory burden for the banking industry, as this data is routinely used in the mortgage origination process, as well as the portfolio management process, and is readily available.

*P. 13 Banking organizations would determine the LTV of a mortgage loan after consideration of loan-level private mortgage insurance (PMI) provided by an insurer with an NRSRO-issued long-term debt rating of single A or higher. However, the Agencies currently do not recognize portfolio or pool-level PMI for purposes of determining the LTV on an individual mortgage. Furthermore, the Agencies note that reliance on even a highly-rated PMI insurance provider has some measure of counterparty credit risk and that PMI contract provisions vary, which provides banking organizations with a range of alternatives for mitigating credit risk. Arrangements that require a banking organization to absorb any amount of loss before the PMI provider would not be recognized under this approach. In addition, the Agencies are concerned that a blanket acceptance of PMI might overstate its ability to effectively mitigate risk especially on higher risk loans and novel products. Accordingly, to address concerns about the PMI, the Agencies could place risk-weight floors on mortgages that are subject to PMI.*

We strongly support the Agencies' proposal to consider the impact of loan-level PMI when determining the LTV of individual loans. Loan-level coverage provided by an insurer with a long-term debt rating of A or higher by an NRSRO is a valuable risk mitigation tool, and does significantly lower the risk of the transaction for the bank. We also appreciate the Agencies' concern with pool-level PMI, shared-risk PMI, and the fact that counter-party risk still exists. To that end, we would support risk-weight floors on mortgages subject to PMI. However, it would seem appropriate to consider setting lower floors for mortgages that are covered by loan-level PMI, those covered with PMI from highly rated insurers, and those that are deemed not "high risk" or "novel product." That is, set the floors to be sensitive to the actual type of insurance risk, counterparty risk, and risk of the underlying mortgage product.

In addition to consideration of PMI, we believe the Agencies should allow for determination of the LTV after consideration of pledged liquid assets. A Pledged-Asset Mortgage allows borrowers to finance a home without liquidating investments to fund a down payment. Since the pledged liquid assets provide a valuable risk mitigant, we believe they should be considered when determining LTV for risk capital purposes.

*P. 13 The Agencies seek comment on (1) the use of LTV to determine risk weights for first lien one-to-four family residential mortgages, (2) whether LTVs should be updated periodically, (3) whether loan-level or portfolio PMI should be used to reduce LTV ratios for the purposes of determining capital requirements, (4) alternative approaches that are sensitive to the counterparty credit risk associated with PMI, and (5) risk weight floors for certain mortgages subject to PMI, especially higher-risk loans and novel products.*

Comments on all these issues are noted above, with the exception of (2), whether LTVs should be updated periodically. While changes in property value and/or the principal balance of the loan result in variations of LTV's, requiring such updates would be a significant financial and operational burden on most banks. As many banks have thousands, or tens of thousands, of loans in their portfolio, obtaining new collateral valuations used in recalculating LTV's on every loan in a bank's portfolio would result in a significant cost and administrative burden. While banks do update their LTV ratios for loans in default, and some banks periodically update LTVs on their highest risk loans (i.e. high LTV), it is not routine or practical to update the collateral value on all loans in a mortgage portfolio.

It is also important to take into consideration the role that a bank's Allowance for Loan and Lease Losses (ALLL) play in supporting this risk. The purpose of the ALLL is to cover the losses in the loan portfolio, from the inherent risk of borrower default and loss on sale of collateral. To the extent that a bank holds a concentration of high LTV loans, loans to borrowers with low credit worthiness, or higher risk or novel product loans, consideration should be reflected in their ALLL.

For these reasons, we do not feel it is practical to require banks to periodically update the LTVs on their entire mortgage portfolio.

*P. 13 The Agencies are also considering alternative methods for assessing capital based on the evaluation of credit risk for borrowers of first lien one-to-four family mortgages. For example, credit assessments, such as credit scores, might be combined with LTV ratios to determine risk-based capital requirements. Under this scenario, different ranges of LTV ratios could be paired with specified ranges of credit assessments. Based on the resulting risk assessments, the Agencies could assign mortgage loans to specific risk-weight categories. In the illustration provided by the Agencies, the risk decreases as the LTV decreases and the borrower's credit assessment increases, which results in a decrease in capital requirements. Mortgages with low LTVs that are written to borrowers with higher credit worthiness might receive lower risk weights; conversely, mortgages with high LTVs written to borrowers with lower creditworthiness might receive higher risk weights.*

We strongly support the Agencies' proposal to consider the credit assessment of the borrower, as well as the collateral LTV, in determining risk-based capital requirements. Moreover, we agree that the use of industry standard Fair Isaac Co. (FICO) type of credit

bureau risk scores should be the form of credit assessment used for the borrowers. The Agencies correctly believe that the combination of both the collateral LTV and the borrower's credit worthiness will result in the most appropriate risk-weighted categories. We feel that the industry would be well-served by the Agencies creating a matrix that associates LTVs in the first dimension with FICO scores in the second dimension; the resulting elements of this matrix would provide risk-weights that reflect appropriate, risk-adjusted, capital requirements. Allowing capital requirements to decrease as collateral and borrower credit quality improves is a prudent, sound approach to the risk-weighted capital guidelines.

*P. 14 Another parameter that could be combined with LTV ratios to determine capital requirements might be a capacity measure such as a debt-to-income (DTI) ratio. The Agencies seek comment on (1) the use of an assessment mechanism based on LTV ratios in combination with credit assessments, debt-to-income ratios, or other relevant measures of credit quality; (2) the impact of the use of credit scores on the availability of credit or prices for lower income borrowers, and (3) whether LTVs and other measures of credit worthiness should be updated annually or quarterly and how these parameters might be updated to accurately reflect the changing risk of a mortgage loan as it matures and as property values and borrower's credit assessments fluctuate.*

While we do support the use of combining LTV and industry standard FICO type credit scores in a risk-weighted capital guideline, as noted above, we do not support the inclusion of a capacity measure such as debt-to-income ratio (DTI). Our concern regarding the inclusion of such a measure is two-fold: (1) DTI is a much more subjective measurement than LTV or FICO score, and is not consistently calculated and applied by all lenders. Different lenders will calculate both income and debts using various guidelines. Additionally, some lenders will base DTI calculations only on verified income, while others may rely on stated income. There is too much variability in how this measurement is calculated and applied for it to be a meaningful guide to risk-based capital guidelines. And, (2) statistics have shown that DTI is a much less robust predictor of probability of default, or loss given default, than FICO scores and LTVs.

We do not believe that the use of credit scores in the risk-based capital guidelines will have a negative impact on the availability or price of credit to lower income borrowers. While the cost of capital can generally affect loan availability and price, we do not believe that applicant income is necessarily correlated with credit score. Many applicants with lower incomes have acceptable credit scores, while many applicants with high incomes have unacceptable credit scores. Banks are motivated to grant loans to generate revenue and profit, and most banks have very progressive mortgage programs for lower-income and first-time homebuyers. The Community Reinvestment Act provides additional motivation for banks to reach out to meet the credit needs of the low-to-moderate income borrowers in their assessment areas.



The difficulty in obtaining periodic updates to LTV ratios is addressed in our comments earlier in this letter. Requiring periodic updates to FICO scores is more feasible. Agencies are now encouraging banks to obtain periodic credit score “refreshes” on their portfolios; many do as a routine part of their risk management program. Such a requirement, however, might prove to be burdensome to many banks. It is both costly to obtain periodically updated credit scores and administratively burdensome to perform the analysis required to discern the score migration. Banks should routinely consider credit score changes in their ALLL analysis. However, it would be an unnecessary complication to the risk-based capital guidelines.

*P. 14 The Agencies are interested in any specific comments and available data on non-traditional mortgage products (e.g., interest-only mortgages). In particular, the Agencies are reviewing the recent rapid growth in mortgages that permit negative amortization, do not amortize at all, or have an LTV greater than 100%. The Agencies seek comment on whether these products should be treated in the same matrix as traditional mortgages or whether such products pose unique and perhaps greater risks that warrant a higher risk-based capital requirement.*

We appreciate the Agencies’ concern regarding “non-traditional” mortgages, and agree that some might warrant a higher risk-based capital requirement than “traditional” mortgages. We would advise caution, however, in how those terms are defined. We would agree that mortgages might be considered “non-traditional” if they permit negative amortization, do not amortize at all, contain “payment options”, or allow for LTV’s greater than 100%. However, we would suggest that all Interest-Only (IOs) loans do not necessarily fall into that category. While some IOs certainly bear some or all of the “non-traditional” characteristics noted above, many do not, and are structured to reset after a prescribed period so that they begin “normal” amortization. Additionally, while IO loans might carry a higher risk of default if not provided to the right borrower, they can be a useful cash flow management tool and very appropriate for borrowers in certain circumstances.

We would suggest that IO loans not be painted with the same broad brush as other “non-traditional” mortgages such as those that offer negative amortization, but rather be categorized based upon how they are structured. If IO mortgages are structured to reset after a specified period as amortizing loans, and do not bear the other characteristics noted above, we believe they should be included in the same matrix as traditional mortgages. In such cases, the underlying FICO score and LTV are likely more meaningful measures of their probability of default, and loss given default, respectively, than the fact that they allow a fixed period of IO payments.

*P. 14 If a banking organization holds both a first and a second lien, including a home equity line of credit (HELOC), and no other party holds an intervening lien, the Agencies' existing capital rules permit these loans to be combined to determine the LTV and the appropriate risk weight as if it were a first lien mortgage. The Agencies intend to continue to permit this approach for determining LTVs.*

*For stand-alone second lien mortgages and HELOCs, where the institution holds a second lien mortgage but does not hold the first lien mortgage and the LTV at origination (original LTV) for the combined loans does not exceed 90%, the Agencies are considering retaining the current 100% risk weight. For second liens, where the original LTV of the combined liens exceeds 90%, the Agencies believe that a risk weight higher than 100% would be appropriate in recognition of the credit risk associated with these exposures. The Agencies seek comment regarding this approach.*

We strongly suggest that the Agencies re-consider their proposal for the risk-based capital requirements for second lien mortgages and HELOCs. The current proposal would require 100% risk weight for HELOCs with combined loan-to-value ratios (CLTVs) of 90% or less; and would require higher than 100% risk weight for HELOCs with CLTVs that exceed 90%. We believe that this approach would grossly over-weight the required capital. Data from the Agencies fourth quantitative impact study of the potential effects of applying Basel II requirements suggest large banks fully implementing Basel II could see reductions of 74% to the capital required to support HELOCs<sup>6</sup>. As such, retaining the current 100% risk weight could create material distortions in the amount of regulatory risk-based capital requirements for large and small institutions, the avoidance of which is a guiding principal of this ANPR.

We recommend that an approach similar to that suggested for first mortgages be applied to HELOCs. That is, base the risk weight on a matrix that considers both CLTV and the credit score. That would allow for much greater consistency between the products. Arguably, a HELOC with a 30% CLTV is less risky than a first mortgage with an 80% LTV. However, in the current proposal, the HELOC line example would carry a 100% risk weight, while the first mortgage loan example would carry a 35% risk weight. We appreciate the increased credit risk of being in a second lien position behind another first mortgage lender. However, the proposed risk weighting of 100% or higher for all HELOCs is creating a "one-size-fits-all" scenario that the ANPR seeks to avoid in the first mortgage portfolios. We suggest that a more risk-based approach consider a combination of CLTV and credit score; this is consistent with the suggested approach for first mortgage loans and is more in-line with the

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<sup>6</sup> While preliminary, data as of May 5, 2005 from the Agencies "Quantitative Impact Studies" suggest the amount of Tier 1 capital and Tier 2 elements other than reserves needed to meet the minimum capital requirement would decrease 74% on HELOCs for large bank adopters of Basel II. (Results released with Congressional testimony before the "Subcommittee on Financial Institutions and Consumer Credit and Subcommittee on Domestic and International Monetary Policy, Trade, and Technology of The Committee on Financial Services" – U.S. House of Representatives. May 11, 2005)

Agencies' guiding principals for this ANPR. The matrix could be modified to require a lower CLTV on the HELOC to achieve the same risk weighting as a first mortgage with the same credit score. This loan to value cushion would help to offset the increased risk from the HELOC being in a second lien position.

### **Loans 90 Days or More Past Due or in Non-Accrual**

*P. 16 Under the existing risk-based capital rules, loans generally are risk-weighted at 100% unless the credit risk is mitigated by an acceptable guarantee or collateral. When exposures (for example, loans, leases, debt securities, and other assets) reach 90 days or more past due or are in non-accrual status, there is a high probability that the financial institution will incur a loss. To address this potentially higher risk of loss, the Agencies are considering assigning exposures that are 90 days or more past due and those in non-accrual status to a higher risk-weight category. However, the amount of the exposure to be assigned to the higher risk-weight category may be reduced by any reserves directly allocated to cover potential losses on that exposure. The Agencies seek comment on all aspects of this potential change in treatment.*

We would agree that unsecured loans that are 90 days or more past due or in non-accrual status carry a high probability of loss that may warrant increased risk-weighted capital. However, we want to clarify that this requirement should not apply to secured loans, particularly those secured by real estate. Consideration should be given to loans that are "well-secured and in the process of collection." For example, even a loan in the course of a bankruptcy filing or foreclosure action, while it may be seriously delinquent, may be supported by collateral with such a low LTV that it bears no material loss exposure. Alternatively, there may be a viable, verifiable, and imminent source of repayment outside liquidation of the collateral, such as insurance payoff, etc. Lenders are already required to cease interest accruals on such seriously delinquent loans, write them down to their net realizable value, and/or carry specific reserves to cover them. We suggest that the addition of higher risk weightings therefore are not applied to such secured transactions.

### **Small Business Loans**

*P. 17 Under the Agencies' risk-based capital rules, a small business loan is generally assigned to the 100 percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. Banking institutions and other industry participants have criticized the lack of risk sensitivity in the risk-based capital charges for these exposures. To improve the risk sensitivity of their capital rules, the Agencies are considering a lower risk weight for certain business loans under \$1 million on a consolidated basis to a single borrower.*

*Under one alternative, to be eligible for a lower risk weight, the small business loan would have to meet certain requirements: full amortization over a period of seven years or less, performance according to the contractual provisions of the loan agreement, and full protection by collateral. The banking organization would also have to originate the loan according to its underwriting policies (or purchase a loan that has been underwritten in a manner consistent with the banking organization's underwriting policies), which would have to include an acceptable assessment of the collateral and the borrower's financial condition and ability to repay the debt. The Agencies believe that under these circumstances the risk weight of a small business loan could be lowered to, for example, 75 percent. The Agencies seek comment on whether this relatively simple change would improve the risk sensitivity without unduly increasing complexity and burden.*

We agree with the Agencies that a lower risk weighting for certain business loans would improve risk sensitivity in the risk-based capital charges for these exposures. In the ANPR, the Agencies outline specific criteria that should be met to achieve the suggested lower risk weighting. However, we believe the Agencies have not given sufficient weight to the collateral that might be securing the small business loan. Schwab's experience with small business loans has been on an accommodation basis for well establish private banking clients. In such instances, the small business loan is generally guaranteed or co-signed by the principal and collateralized by either an appropriately margined lien against a single-family residence or by marketable securities. In either case, our experience is the loss potential on the loan has far more in common with a mortgage or a line of credit backed by marketable securities than it does with a traditional commercial loan. As such, we recommend the Agencies allow for a similar risk weighting on such small business loans as would be applied against a similarly collateralized mortgage or securities backed line of credit.

### **Summary**

In addition to the areas addressed in the ANPR, we believe the Agencies must address other key asset classes such as loans secured by marketable securities, HELOCs, and others to adequately meet the guiding principals outlined. We will close with a quote from Thomas J. Curry, Director Federal Deposit Insurance Corporate from his May 11, 2005, Basel II statement to a subcommittee of The Committee on Financial Services, U.S. House of Representatives, which we feel well encapsulates this issue.

*"Absent a substantial reduction in capital requirements for non-Basel II banks, implementing risk-based capital requirements along the lines depicted in the QIS-4<sup>7</sup> results could have profound competitive implications and could significantly*

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<sup>7</sup> In the light of all the changes culminating in the Basel Committee's 2004 mid-year text, the U.S. Agencies embarked on a fourth quantitative impact study, QIS-4. QIS-4 is a comprehensive effort completed by 26 large U.S. consolidated banking organizations during late 2004 and early 2005. The purpose of the impact study was

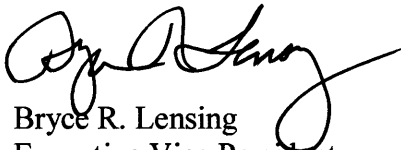
Office of the Comptroller of the Currency  
Board of Governors of the Federal Reserve System  
Federal Deposit Insurance Company  
Office of Thrift Supervision  
January 17, 2006

*charles* SCHWAB

*harm the community banking sector in the U.S., as well as large non-adopters. In our market economy, assets and lending will migrate to where it is most economical to house them. Today, risk-based capital requirements for identical assets are identical across banks so that there is no systematic regulatory capital economy achieved by moving an asset from a small bank to a large bank. Basel II would appear to create significant differences between the capital requirements of small and large banks for many activities. Owners of small banks will receive sub-par returns on their investments in capital-disadvantaged assets compared to the returns that owners of large banks could earn on the same assets. As a result, market forces would likely drive those assets over time away from smaller banks, toward the Basel II adopting banks.”*

We applaud the Agencies' general approach as guided by the principals outlined in the ANPR. The Charles Schwab Corporation shares these guiding principals and has given thought to each when formulating our response to the ANPR. Providing appropriate risk-based incentives for banking organizations and mitigating asymmetry in the amount of regulatory risk-based capital requirements for large and small institutions are among the most important of these guiding principals. We look forward to additional dialogue on this important subject and can be reached via the contact information below.

Sincerely,



Bryce R. Lensing  
Executive Vice President  
Risk & Credit Management  
The Charles Schwab Corporation

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to use these organizations' internal estimates of the key risk parameters driving capital requirements for credit risk and operational risk under the Basel II framework.