January 18, 2006

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

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

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

Dear Ladies and Gentlemen:

ING Bank, fsb (ING DIRECT) appreciates the opportunity to provide comment on the advance notice of proposed rule making entitled "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications" (referred to as the Basel IA). ING DIRECT, a subsidiary of ING Group, with $54 billion in assets, provides retail banking services and financial products to individuals and businesses across the United States of America.

Because its parent, ING Group, is subject to Basel II standards in the European Union, ING DIRECT is in an almost unique situation to submit a comment on Basel IA. ING DIRECT is required to undertake many of the analyses required by Basel II in order to enable its parent to comply with the standards made applicable in the EU. As a domestic federal savings bank, though, ING DIRECT also must comply with the capital standards applicable in the U.S. ING DIRECT also may choose to be covered by Basel II standards in the U.S. ING DIRECT respectfully submits these comments informed by its exposure to these differing standards.

In our view, the Agencies are missing a crucial opportunity to put the US banking system on par with its international counterparts. Rather than adopting the faint-hearted proposal that has been proposed in Basel IA, ING DIRECT urges the Agencies to take this opportunity to implement the full Basel II agenda for all U.S. financial institutions. The world is moving forward. The proposed Basel IA reflects a retreat from the sound principles and procedures that have been developed in long and difficult consultations among the international banking community. Rather than leading the process, the Agencies are pulling back from the consensus reached worldwide. ING DIRECT urges the Agencies to reconsider and make all of the Basel II approaches available to all U.S.

banks. To the extent that some small banks cannot absorb the cost of developing and implementing appropriate internal risk systems expected under Basel II, the OTS should develop credit risk alternatives similar to the guidance the OTS developed earlier for interest rate risk.

Otherwise, however, ING DIRECT generally supports the Agencies' efforts to revise the current risk-based capital guidelines in order to enhance the risk sensitivity of the regulatory capital framework, to encourage the development of sound risk measurement and management practices, and to address competitive equity questions that may be raised by U.S. implementation of the Basel II framework.

ING DIRECT supports the approaches outlined in the Basel IA proposal such as increasing the number of risk-weight categories and using updated loan-to-value ratios for assigning risk weights to residential mortgages. ING DIRECT believes these changes will enable banks to better align regulatory capital requirements to underlying economic risks, to encourage better risk measurement processes, and to discourage excessive risk taking activities.

Nevertheless, as we discuss in more detail below, ING DIRECT perceives that the proposed Basel IA

- does not adequately recognize lower risk sensitivities of certain bank assets,
- does not align risk-based capital with levels suggested by U.S. Basel II,
- does not sufficiently allow use of internal credit risk ratings, and
- does not adequately address international competitive equality issues.

One stated objective of Basel IA is to help resolve potential competitive inequalities that implementation of Basel II may produce for banks remaining on the Basel I standard. The proposal does not go far enough in addressing such differences for banks in the U.S.

In addition, the Agencies have determined in connection with Basel II to permit U.S. financial institutions to use only the Advanced IRB approach. ING DIRECT suggests that the Agencies should consider enabling more U.S. banks to adopt the other two approaches that are permitted in the international Basel II Accord (Standardized approach and Foundation IRB[1] approach). By allowing three alternative approaches to the implementation of Basel II, U.S. banks would be put on the same level playing field with banks in other countries, while the risk sensitivity of credit risk could be improved.

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[1] The proposed Basel IA resembles the Basel II Foundation IRB approach in the context of external credit ratings based approach.

ING DIRECT also suggests that the Agencies take a flexible approach and allow banks to adopt portions of the new standards. The proposed capital rules draw sharp distinctions between methodologies to be used for separate kinds of assets. To the extent that a bank is active with respect to one type of asset, the regulatory burden of complying with the new rules is warranted. That bank should be allowed to adopt the new rules with respect to that class of assets, though, while adhering to simpler, less burdensome, standards for classes of assets that are less material to the bank.

Despite generally supporting the proposal, ING DIRECT remains concerned about the retention of the leverage capital requirement. The leverage capital requirement results in an excess capital charge against low risk assets such as mortgages and investment securities. As OTS Director John Reich noted in his recent testimony before the Committee on Banking, Housing and Urban Affairs, a risk-insensitive leverage ratio works against a financial institution's investment in low-risk assets and such a system may perversely motivate low credit risk lenders to pursue riskier lending. The retention of a leverage capital ratio that is not adjusted for credit risks, interest rate risks, liquidity risks or operational risks works directly contrary to the goal of the Basel process, which is to enhance the risk sensitivity of the regulatory capital framework. We strongly encourage the Agencies to consider removing the risk-insensitive Well-Capitalized Leverage Ratio for financial institutions, make it risk-sensitive, or at least significantly lower the ratio for savings organizations with significant residential mortgage exposures.

In assessing a bank's overall risk, we also suggest that the Agencies review each bank's risk level and risk management through a supervisory review process similar to the Basel II Pillar II standard.

Below we provide more specific comments and questions based on our understanding of the Basel IA proposal.

Specific Basel IA Proposals

1. *Increase Number of Risk-Weight Categories*

ING DIRECT believes that increasing the number of risk-weight categories would allow supervisors to more closely align capital requirements with risk and additional risk-weight categories would improve the risk sensitivity of the existing capital standards. The revised risk weight categories may also lead to improved returns, as pricing may be better aligned with risk as a result. Lowering the risk-weight requirement for investment grade assets is prudent.

The Agencies should consider a framework, however, that requires less capital for securitizations based on credit rating alone. The formulation of the Ratings-Based Approach under Basel II and the accompanying research that led to its formation is evidence that the credit risk in corporate bonds and securitizations are significantly different. Any interim Basel framework that does not partially reflect this difference will likely make the ultimate transition more disruptive to thrifts and the financial markets than should be necessary.

ING DIRECT proposes that lower than 20% risk-weight categories, such as 10%, should be warranted for the highest quality securities with very low probability of default (i.e. A+ rated and above exposures). For example, under the current Basel II framework, a less than 10% risk-weight is applied to some highest rated senior securities backed by the granular pools even if adding possible operational risk capital requirement (i.e. AAA rated receives 7% risk-weight and AA rated receives 8% risk-weight). In the Basel IA proposal, similar securities will receive a 20% risk-weight, which results in a much higher capital requirement than would occur under Basel II. As Basel IA intends to create appropriate incentives for banking organizations and resolve the potential competitive inequalities Basel II may produce for banks remaining on the Basel I standard, the distortion between Basel IA and Basel II capital requirement should be mitigated. We would highly encourage the introduction of additional lower risk-weight categories commensurate with Basel II. In addition, the granularity criteria should be extended to Basel IA as it is not overly burdensome to report.

The proposed risk weights for non-investment grade exposures are acceptable. Non-investment grade exposures should require additional capital charge given historical default rates for these classes. Financial institutions seeking higher returns at the expense of credit quality should be required to hold additional risk capital.

ING DIRECT does not believe that an increased number of risk-weight categories would place unnecessary burdens on banking organizations. An increased number of risk-weight categories would help enhance the risk sensitivities of the capital framework and align the risk more closely with the underlying credit exposures.

Those that invest in higher quality/lower risk rated assets will benefit financially in that these institutions can lower risk weighted capital levels to support those asset classes. Conversely, those that seek the highest possible returns and are willing to accept (knowingly or otherwise) the risk associated with that business approach, will need to demonstrate adequate capital levels to ensure solvency in the event of adverse credit events

2. *Use of External Credit Ratings*

Most of the risk-weight categories for NRSRO ratings are appropriately risk sensitive, though lower than 20% risk-weight categories such as 10% should be warranted for the highest quality securities with very low probability of default such as AAA and AA rated senior asset and mortgage-backed securities. The proposed higher risk weighting is appropriate in the lower end of the credit spectrum. If appropriately managed, banks will pay closer attention to pricing and risk-return issues because of the added cost of capital required to purchase those higher risk/lower rated sensitive assets. This should create a more adequately capitalized environment and competitive playing field for all financial institutions.

For unrated exposures, one approach such as an internal risk rating system could be utilized to map internal grades to expected losses. For commercial lending, for example, one way could entail establishing a borrower grade based on financial characteristics (e.g. net worth, balance sheet leverage, operating performance, etc). Once the borrower grade is established, the transaction risk can be modified up or down based on the value offered by such items as collateral type and value relative to the exposure, and strength of guaranties/sureties, if any, supported by net worth, income, liquidity, and credit scores/bureau scores.

3. *Expand Recognized Financial Collateral/Guarantors*

ING DIRECT agrees that expanding the scope of eligible collateral would improve risk sensitivity without being overly burdensome. So long as the collateral system marks to market the underlying marketable securities daily and there is appropriate margin to allow for modest price fluctuation, banks could base risk weighting on liquidity of the collateral. Restricting collateral/guaranty type to investment grade securities or sponsorship (for guarantee purposes), is prudent in setting risk weighting for capital purposes.

ING DIRECT supports expanding the scope of recognized guarantors to include any entity whose long-term senior debt has been assigned an external credit rating of at least investment grade by an NRSRO Using the long term debt rating of the guarantor or sponsor for risk weighting purposes would be prudent so long as the guarantee is unconditional and not limited in any way.

ING DIRECT generally agrees that using a ratings-based approach for determining the risk weight applicable to a recognized guarantor is easy to apply and would not cause any burden to implement.

In the event of an unconditional guarantee, the risk weighting calculation should be a function of the long term debt rating and a ratings-based approach could be applied. For instance, an A rated institution would receive a 35% risk weight, so long as its long term debt rating remains unchanged. To the extent a rating change occurs (up or down) the risk weight would change in a similar direction at the requisite risk weighted level. Banks would be required to maintain an internal system that tracks changes in debt rating if they chose to implement this approach. Relying on the instrument rating, as opposed to the guarantor rating should be the default. If the guarantor does not have a useful or reliable rating, the risk weighting should be the same as would be applicable to the instrument if there were no guarantor.

4. *1-4 Family/Multifamily Residential Mortgages*

A. First Lien One-to-Four Family Residential Mortgages

ING DIRECT supports refining the existing "one size fits all" approach to risk-based capital for residential mortgage exposures. An industry study has shown that large banks that adopt the Basel II risk-based capital rule would enjoy an advantage of up to 15 basis points – or 5 percent – of the cost of financing a mortgage investment over those subject to the existing Basel I rule.[2]

ING DIRECT believes that, in the first instance, the Agencies should allow banks to rely on internal credit risk rating systems, if the systems are sufficiently robust and reviewed without objection by the bank's regulator. The best way to implement true risk-based management is to encourage all banks to develop and adopt robust systems, and enabling banks to implement systems that can materially affect their capital charge is one of the best ways of provide appropriate incentives to develop such systems.

The LTV ratio plays an important role in measuring mortgage credit risk and, if the Agencies decline the invitation to allow widespread reliance on internal credit risk rating systems, it certainly makes sense to use LTV to vary risk weights for residential mortgages. The use of LTV to more properly assign risk is certainly better than the current 50% risk weight for most residential mortgage loans.

ING DIRECT believes that risk weights per LTV segments proposed in Basel IA appear to be too high compared with the levels of the risk-weights that would be imposed under Basel II. Our internal Basel II analysis shows that the risk-weight

[2] An Examination of How the Proposed Bifurcated Implementation of Basel II in the U.S. May Affect Competition among Banking Organizations for Residential Mortgages by Paul Calem and James Follain, January 2005.

of prudently underwritten mortgage loans with LTV ratios of less than 80 percent would be below 10% and the risk-weight of the same type of loans with LTV ratios of less than 90 percent would be below 20%. ING DIRECT strongly suggests the risk-weight categories for first lien residential mortgages be lowered to be commensurate with the Basel II standard to address competitive equality concerns.

The calculation of LTV, however, needs to be clarified by the Agencies. The current ambiguity could lead to different perceived levels of risk based capital ratios and cause inconsistent application of the rule.

We would prefer an LTV measurement that makes sense, and one that is not overly costly to produce. ING DIRECT suggests that the appropriate LTV would be one that is updated periodically to reflect the reduction in the loan balance because of principal payments, but one that is not updated to try to accommodate changes in property value. The loan balance is easily updated on a regular basis. Updating the "Value" part of LTV is much more difficult.

Not including updates for changes in property value is, in general, a conservative approach because, over the long term, housing prices are rising. If increases in property values affected LTV, it would tend to reduce capital requirements. If banks use the method we recommend, they should not be allowed to make frequent switches in methodology, in particular during a period with large scale price decline

While it might be theoretically possible to update property values, the cost and regulatory burden of doing so is prohibitive. Traditional valuation methods are far too expensive and time consuming to be performed on a quarterly or even annual basis. AVM's[3] are an extremely useful valuation tool, less costly, quicker and usually as accurate, but AVM's are still expensive for a whole portfolio and are not a 100% nationwide solution. AVM's are only effective in areas with sufficient data, currently about 1500 counties. A recent nationwide AVM acquisition revealed a significant portion of the data to be inconclusive even when supplemented with house price index data. Housing price indices alone are inappropriate to update valuations because of the difficulty in matching regional indices with actual portfolios.

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[3] AVM – Automated Valuation Model. A computer generated opinion of value derived from a variety of statistical methods that utilize real estate market data.

Overall, then, to avoid undue reporting burden and reduce the costs of implementation, ING DIRECT proposes that a static at origination property value approach should be applied to determine the regularly updated LTV.

In addition, to the extent that changes in LTV are used to modify risk-weightings, ING DIRECT strongly suggests that impacts on capital requirements from changes in LTV and other measures of creditworthiness should be updated no more frequently than annually. Quarterly quantification of the LTV and other measures will incur significant implementation costs, while leading to few if any, changes in overall capital quarter-to-quarter.

B. Private Mortgage Insurance (PMI)

ING DIRECT strongly urges that the portfolio or pool level of PMI should be recognized for the purpose of determining the LTV of an individual mortgage. The portfolio or pool level PMI provides the same risk mitigation as the loan level.

ING DIRECT believes that risk-weight floors are unnecessary as long as banks manage this type of loan prudently and provide necessary credit risk mitigation. Risk-weight floors for certain mortgages will increase the complexity of risk weighting exponentially, and will discourage banks from adopting Basel IA.

C. The Use of An Assessment Mechanism

Use of an assessment mechanism would be ideal if the current system had the capability to maintain and update these assessment measures. Credit assessments such as credit scores would be acceptable to ING DIRECT. Debt-to-income ratios are not readily available, however, and it would be very difficult and costly to conduct ongoing verification. Moreover, for some customers, credit scores may not be available or reported, which could cause difficulties for the assessment.

ING DIRECT recommends that the Agencies consider allowing banks to use their own internal risk rating system to segment the portfolio and assign risk-weights. By allowing the internal risk score approach, the risk sensitivity of underlying exposures would be better measured based upon internal data. At the same time the Agencies would be promoting a sound risk management practices and create appropriate incentives for banking organizations.

5. *Other Retail Exposures*

Currently most of other retail exposures other than first lien mortgages risk are weighted at 100%. This "one size fits all" approach does not base the risk weight category on risk-sensitive measures. ING DIRECT believes that credit assessments such as LTV and credit scores, updated periodically, would increase risk sensitivity without creating undue burden. By allowing a risk sensitive approach, banks would be able to assign lower than 100% risk weight for the high credit quality other retail exposures.

6. *Short-Term Commitments*

ING DIRECT recommends that the Agencies continue to assign 0% credit conversion factor (CCF) for short-term commitments and 50% CCF for long-term commitments. ING DIRECT believes that one single CCF would not make the underlying exposure more risk sensitive. If a company has significant long term commitments, the single CCF would not justify the credit risk level.

7. *90 Days or More Past Due or in Nonaccrual*

ING DIRECT suggests that the Agencies retain the current risk-weight treatment for loans that are 90 days past due or in nonaccrual status.

8. *Commercial Real Estate Exposures*

ING DIRECT strongly supports the Agencies' continued assignment of a maximum 100% risk-weight to commercial real estate exposures. Commercial Real Estate lending has proven historically less risky than other forms of commercial loan exposures. In addition, current underwriting and risk management practices are stronger now than in the past. For loans not satisfying the Interagency Real Estate Lending Standards regulations, we suggest the Agencies monitor these loans through the supervisory review process and not through increased capital requirements. It is already clear that banks need to demonstrate prudent risk management in this arena. An increase in capital charges to address supervisory issues will produce the opposite of the desired effect by pushing underperforming banks to reach for higher risk transactions in order to produce the extra fees and interest charges needed to compensate for higher capital charges.

Accordingly, ING DIRECT encourages continued use of the 100% risk-weight to commercial real estate exposures. In the event the agencies seek alternative

assignments, such changes should only be required on a portfolio basis rather than an individual loan basis or at the very least on a borrower basis. Once the borrower grade is established, the transaction risk can be modified up or down based on the value offered by such items as collateral type and value relative to the exposure, and strength of guaranties or sureties, if any, supported by net worth, income, liquidity, and credit scores or bureau scores. The resulting grade could then be mapped to the appropriate risk weight percentage.

Basel IA Application

ING DIRECT believes that the Agencies should not impose an asset size threshold to determine which institutions may adopt the revised capital framework. Banks should be given the flexibility of choosing a suitable capital framework based on their own situations.

In addition, the Agencies should allow banking organizations to choose among alternative approaches for some of the proposed modifications. A bank's assessment of the financial burden that results from a proposed modification is dependent upon how much its capital charges will be reduced for less risky assets. Once a bank chooses the appropriate framework, additional risk weight categories should only apply to material portfolios. Immaterial portfolios should not be subject to the new applicable risk-weight category, thereby limiting the financial and operational burden and regulatory oversight. The method of assessing capital adequacy should be appropriate to the size and complexity of each bank's balance sheet and business model.

Basel II Capital Floor

ING DIRECT believes that there should be no capital floor for the Basel II capital framework. The capital floor should be a dynamic variable reflective of the bank's business model. An institution with highly risk-adverse assets should not be overly penalized relative to a bank with highly risky assets. This would defeat the spirit of Basel IA and Basel II, especially with additional capital assessments for operational risk and potentially interest rate risk. A capital floor is essentially a floor on risk-adverse assets. Confidence in risk-weighting assets for capital assessments should remove the minimum "one size fits all" capital requirement.

ING DIRECT notes that the minimum capital requirement could drop measurably for those banks with a concentration in residential mortgages under Basel IA. Therefore it could cause the current proposed Basel II floor based on Basel I standards to be too high. If, however, the Agencies decide to implement the floor, ING DIRECT suggests that the revisions that result from Basel IA should be incorporated into the definition of the Basel II capital floor.

Reporting Requirements

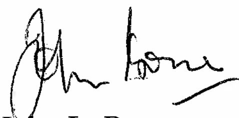
The reporting requirement burden will increase as the numbers of factors determining risk weighted assets increases. Organizations will need to streamline communication and reporting processes through various departments in order to correctly calculate risk weighted assets. In addition to an increased reporting requirement based upon increased factors, the frequency of these updates will have an additional burden on the business and reporting. For example, the required frequency of LTV or credit score updates will affect the business' need to obtain such updates and report or coordinate the proper and accurate reporting of these factors.

Additionally, for international banks whose parents may adopt Basel II, maintaining two sets of reports will significantly increase reporting requirement burdens. The more Basel IA and Basel II can be aligned, the greater the reduction of burden to the business.

Summary of Conclusions

In summary, if the Agencies will not fully implement Basel II, we generally support the approach outlined in the Basel IA but remain concerned by the potential inconsistency in capital requirements between Basel IA and Basel II, the continued leverage capital requirement, and the practical issues regarding the assigning of risk weights to residential mortgages. Once again we would like to thank the Agencies for their effort to refine the current regulatory capital framework and resolve the potential competitive inequality as a result of Basel II implementation. If you should have any questions regarding this letter, please feel free to contact me at (302) 255-3022.

Sincerely,



John L. Bone
Chief Financial Officer
ING Bank, fsb