June 23, 2005

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

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: Interagency Proposal on the Classification of Commercial Credit Exposures

Dear Mr. Feldman and Ms. Johnson:

The Conference of State Bank Supervisors (CSBS)[1] is pleased to have the opportunity to comment on the interagency proposal regarding changes to the classification system for commercial credit exposures (proposal).

The CSBS Board of Directors unanimously requests that the proposal be withdrawn.

CSBS has fully evaluated the proposal through its Regulatory Committee, which collectively represents more than 30 state banking departments. Additionally, we reviewed the proposal with and received comments from the CSBS Bankers Advisory Board[2] and held outreach sessions for state banking departments and bankers at our 2005 CSBS Annual Meeting and Conference held June 1-3, 2005, to obtain additional feedback. Reaction to the proposal by senior staff within the banking departments as well as executive level bankers has been overwhelmingly negative. The CSBS Board of Directors has discussed the feedback and recommendations received and requests that this proposal be withdrawn. CSBS does not

[1] CSBS is the national organization of state officials responsible for chartering, regulating and supervising the nation's 6,240 state chartered commercial and savings banks and 400 state-licensed branches and agencies of foreign banks.

[2] The CSBS Bankers Advisory Board is the organization's bank membership leadership group, which provides advice and support to the Board of Directors, and serves as a resource to CSBS members and staff throughout the year.

CONFERENCE OF STATE BANK SUPERVISORS

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believe the proposed changes are necessary and sees little benefit in implementing the proposal.

Background

The proposal would replace the current commercial loan classification system categories -- "special mention," "substandard," and "doubtful"-- with a two-dimensional framework. The two-dimensional rating system has one dimension that measures the risk of the borrower defaulting (borrower rating) and a second focuses on the loss severity the institution would likely incur in the event of the borrower's default (facility rating).

Borrower ratings focus exclusively on the borrowers' financial capability and willingness to meet their obligations and are drawn extensively from the current framework. The proposed borrower ratings are "marginal," "weak," and "default".

Facility ratings would be required only for those borrowers rated default and would be based upon a loss severity estimate. There are four proposed estimate ranges, including a "remote risk of loss," where there is likely to be no loss related to recovery, to a "high risk of loss," where the bank expects to lose over 30% of the recorded investment.

The proposal is expected to apply to all financial institutions, and relates to commercial credit exposures.

Analysis and Comment

Although the federal agencies state that the current classification system considers the same borrower and facility factors included in the proposal, the costs associated in requiring all institutions to formally implement the system would add to regulatory burden and increase already strained compliance budgets at small and medium-sized banks. Institutions will likely face increased costs associated with revising policies and procedures, loan review, documentation, system implementation, staff training, internal controls and increased auditor costs. Obviously, state banking departments would face similar challenges to implement the proposal.

Furthermore, as you are already aware, smaller community banks will bear the largest burden of these added implementation costs. These institutions, approximately 80% of which are state chartered, are already struggling to manage regulatory compliance issues with limited staff resources. The state banking departments are concerned about the regulatory burden this proposal would add to the institutions under their supervision.

While it is possible for institutions of all sizes to implement the two dimensional classification system, CSBS sees little benefit, especially considering the potential costs that will be incurred by small to medium-sized banks. The two dimensional ratings are no more clear or necessarily effective than those contained in the current rating framework. The proposal indicates that the current system's ambiguity has lead to different interpretations between regulatory agencies as well as between the agencies and the banks they regulate.

However, there is no real explanation of how or why the newly proposed framework would resolve those issues to any great extent. We are also concerned that the inclusion of the facility test will create a misleading impression in the marketplace that collateral or other aspects of a loan are a substitute for a borrower's creditworthiness.

Conclusion

CSBS strongly urges the agencies to withdraw this proposal. The proposed classification scheme is complicated and burdensome for small and medium sized banks, while the current framework, which has been in place for many years without major change, has provided and continues to provide accurate and sound analysis of commercial credit exposures. CSBS can find no clear reason or necessity for the implementation of this proposal.

If the federal banking agencies continue to evaluate similar classification proposals, we request that state banking departments and CSBS be fully included in the discussion. State banking regulators are partners with the FDIC and Federal Reserve in the effort to create seamless supervision for state-chartered financial institutions. As such, both state and federal banking agencies need to confer and agree on all major regulatory approaches. CSBS and the state banking departments look forward to continuing the strong tradition of working closely with the FDIC and Federal Reserve to strengthen coordinated supervision of state chartered banks.

Thank you for your consideration. We invite you to contact us if we can provide additional information and input.

Best Personal Regards,

Neil Milner

Neil Milner, CAE
President and CEO