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INVESTMENT & LOAN

17 January 2006

Public Information Room
Office of the Comptroller of the Currency
250 E Street, SW
Mailstop 1-5
Washington, DC 20219
Attention: Docket 05-16

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

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

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

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

Ladies and Gentlemen,

Thank you for this opportunity to comment on the October 20, 2005 Advanced Notice of Proposed Rulemaking (ANPR) for Basel IA. Fremont Investment & Loan has reviewed the proposal and offers these comments to the Agencies for their deliberation. We support the Agencies dual task of improving the risk-sensitivity of capital measures while managing regulatory burden and we generally support this proposal, assuming several modifications and the completion of a cost and capitalization impact analysis.

We offer the following comments regarding this proposed rule.

The ANPR background discussion highlights shortcomings with the existing risk-based capital framework, stating that it should be modified to better reflect the risks present in the banking industry at large. It also makes clear the Agencies desire to enhance the risk-sensitivity of the capital charges, "to reflect changes in accounting standards and financial markets, and to address competitive equity questions that, ultimately, may be raised by U.S. implementation of the Basel II framework." We support this goal and the Agencies efforts in achieving it.

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Proposal A – Increase the Number of Risk-Weight Categories

Recommendation – Do not include a 350% risk-weight category

The Agencies request comment on increasing the number of basic risk-weight categories from five to nine; for example, adding 35, 75, 150, and 350 to the existing framework. We agree that increasing the number of risk-weight categories would allow supervisors to more closely align capital requirements with risk, assuming risks are properly assigned to the designated risk-weight category. The dearth of information within this proposal on specific asset class risk-weights under an expanded risk-weight regime impedes an expanded commentary; but we generally favor a more granular approach.

We are concerned, however, with the inclusion of a 350% risk-weight category as it relates to the next highest category of 200%. This is nearly a two fold increase over an already heavy 200% risk-weight category, or 16% capital charge. Asset exposures requiring a 28% capital charge beyond what would likely already have prudently established reserves are demonstrably non-economic exposures and, in all probability, an impermissible investment for an insured financial institution.

Proposal B – Use of External Credit Ratings

Recommendation – Do not include a 350% risk-weight category

We agree that a broader use of Nationally Recognized Statistical Rating Organizations (NRSROs) to assign risk weights is appropriate, but as previously stated we are concerned with the inclusion of a 350% risk-weight category.

Proposal C – Expand Recognized Financial Collateral and Guarantors
We agree with this proposal as presented.

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

Recommendation – Differentiate between held-for-sale and held-for-investment mortgage portfolios

Because Proposal D makes no differentiation between an *investment* portfolio of one-to-four single family residential (SFR) mortgages versus a portfolio that is held-for-sale, it does not adequately enhance the risk-sensitivity of capital charges within this asset class. Empirical data clearly demonstrates that SFR mortgage portfolios held-for-sale have significantly less credit risk exposure than those portfolios held-for-investment. The typical held-for-sale mortgage portfolio turns over between 60 and 90 days, significantly reducing credit risk exposure. Material credit losses are not experienced until after 12 to 18 months, with peak losses occurring in months 24 through 36.

Current regulations already contemplate the reduced exposure associated with held-for-sale mortgage portfolios. For example, Appendix A to Part 365 of the FDIC Rules and

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Regulations – Interagency Guidelines for Real Estate Lending Policies, allows an exclusion from the supervisory loan-to-value limits for loans that are "to be sold *promptly after origination, within recourse, to a financially responsible third party*". Thus, a financial institution may originate and sell one-to-four SFR mortgages beyond the supervisory loan-to-value limits and be shielded from the requirements described in the Interagency guidelines. It is our experience that "promptly" has been interpreted to mean 90 days.

It is also our experience that the exclusion elucidated in Appendix A to Part 365 directly results in a specific capital charge at our institution. We currently originate mortgage loans for sale as one of our business lines. The bank examiners have instructed us to risk-weight these mortgage loans at 50%, *unless* a mortgage loan is above the supervisory loan-to-value limit *and* was originated 91 days prior. Thus, in practice, the capital regulation has already been nuanced by the Agencies, acknowledging the reduced risk associated with held-for-sale mortgage portfolios.

We firmly believe that in order to materially enhance the risk-sensitivity of capital charges within this asset class, the capital regulation should explicitly recognize the reduced risk profile of held-for-sale mortgage portfolios. For instance, we believe it prudent to require a capital charge at the lowest level available for one-to-four SFR mortgages that are held-for-sale for the first 90 days. During this period, a mortgage's susceptibility to credit risk is extremely small and the minimum capital charge would still capture other risks, such as operational and interest rate risks. After 90 days, mortgage loans would then be risk-weighted based upon the various characteristics of the loan as dictated by the regulation.

This approach would promote the Agencies' efforts to enhance the risk-sensitivity of the capital charges, while still assuring a prudent capital charge.

Regarding the proposed approaches, we believe that the least burdensome approach relates specifically to the loan-to-value approach as opposed to a combination of loan-to-value with credit score or debt-to-income ratio approach. Should the Agencies adopt a loan-to-value ratio approach or combination approach, several questions arise:

- Would the Agencies adopt the widely available "FICO" score, thereby officially sanctioning it as the most suitable credit score for capital adequacy assessments?
- Would internally generated credit scores be adequate?
- Would the Agencies promulgate rules regarding the appropriate methodologies for developing internally generated credit scores?
- Would internally generated credit scores be held to the same or similar standards described as the AIRB approach of Basel II?
- How often would credit scores, debt-to-income ratios and loan-to-value ratios require refreshment?

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- Because banks cannot demand updated financial information from mortgage borrowers to refresh debt-to-income ratios, will banks be required to hold additional capital in those instances where refreshed data could not be obtained?
- In refreshing loan-to-value ratios would obtaining automated valuation model (AVM) valuations be adequate?

Clearly the regulatory burden increases if the single loan-to-value ratio approach is considered, and the burden increases exponentially when a combination approach is considered. It is also clear that if such an approach were adopted, some level of data refreshment would be necessary to assure ongoing risk sensitivity in the metrics. We question whether the cost of using a combined approach (with some level of data refreshment requirement) is worth the increased sensitivity that it may bring to the regulatory capital charges. Depending on the frequency and mode of data refreshment, the cost could be prohibitive and add little incremental value. This is especially true for financial institutions primarily involved in originating and selling SFR mortgage loans, as opposed to SFR mortgage loan portfolio lenders. We are also concerned that data consistency issues would likely arise across the industry, especially as it pertains to the calculation of debt-to-income ratios. These calculations lack standardization between institutions and are often subjective.

For this asset class, the Agencies may consider regularly aggregating the data collected from the Basel II bank's and calibrate the regulatory capital charges from this data for the banks that are not required to adopt Basel II. By doing so, the regulatory burden for small and mid-sized banks is not unduly increased while competitive concerns are also addressed through Basel II calibrated capital charges.

Proposal E – Multifamily Residential Mortgages

Recommendation – Conform the treatment of single-family and multifamily mortgage loans

Should the Agencies adopt a loan-to-value approach for one-to-four single family residential mortgages, for consistency purposes we feel it appropriate that a similar consideration be given to multifamily residential mortgage loans. As with single-family residential mortgages, credit losses associated with multifamily residential mortgage loans are substantially driven by collateral value.

Proposal G – Short Term Commitments

Recommendation – Do not use the term of a commitment as a determinant of the capital charge

The Basel Committee (Committee) describes a commitment as follows:

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> *Commitments – Here a bank has committed itself to a future transaction that will normally result in the bank acquiring a credit exposure (either an asset or possibly a guarantee) at some future date.*[1]

This description acknowledges that commitments will result in a bank "acquiring a credit exposure at some future date", meaning the bank has not yet been exposed to credit risk simply by virtue of a commitment. Later, the Committee assigns a capital charge to commitments with an original maturity exceeding one-year via a 50% credit conversion factor saying that the longer maturity broadly serves as a proxy for higher risk facilities.[2] We could not find a published Committee discussion deliberating why a longer maturity should serve as a proxy for higher risk facilities, especially in the context of its comments regarding credit risk related to commitments in general.

Although the Basel Committee believed that all off-balance sheet exposures should be captured within the risk-based capital framework even in situations where exposure to credit risk was small, short-term commitments carried a credit conversion factor of zero resulting in no capital charge. The Committee states:

> *Shorter-term commitments or commitments which can be unconditionally cancelled at any time, it is agreed, generally carry only low risk and a nil weight for these is considered to be justified on de minimis grounds.*[3]

Accordingly, because the Committee believes that all off-balance sheet exposures should be captured within the risk-based capital framework even in situations where exposure to credit risk is small, we agree with the proposal whereby all commitments are assigned a 20% credit conversion factor regardless of commitment term. It is our belief, in deference to the Committee, that the term of a commitment is not a useful proxy for credit risk. Rather, the potential creditor is a useful proxy for credit risk, and this risk is captured via the on-balance sheet risk-weight after conversion; assets of equal risk can be created through either short-term or long-term commitments.

We also suggest that the capital rules allow commitment levels be adjusted for expected usage levels. This is especially true for lines of credit and other commitments whereby the entire commitment will never be fully disbursed throughout its life. The credit conversion factor is meant to capture the *potential* credit risk related to the exercise of that commitment. To convert the commitment at the gross commitment level rather than the expected usage level exaggerates that credit risk potential, and results in a capital charge disproportionate to the credit risk exposure, as acknowledged by the Committee.

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[1] "The Management of Banks' Off-Balance-Sheet Exposures", March 1986, Basel Committee, page 17.
[2] "International convergence of capital measurement and capital standards", July 1988, Basel Committee, page 12.
[3] Ibid, page 13.

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Proposal H – Loans 90 Days or More Past Due or in Nonaccrual

Recommendation – Do not double-count past-due loans in the capital charge

We disagree with this proposal. Under GAAP, banks are required to regularly reserve for loans and other exposures where losses are probable and estimable. Loans 90 days or more past due or in nonaccrual have undergone reserving analyses, as required by GAAP and Call Reporting convention. As such, losses have been identified and properly reserved. Beyond that, an additional 8% layer of capital (assuming a 100% risk-weight for an adequately capitalized institution) is sufficient protection for any additional losses that may go unidentified between reserving analyses.

Proposal I – Commercial Real Estate (CRE) Exposures

Observation – ADC loans are not susceptible to a standardized capital charge computation

We generally disagree that ADC loans, by their nature, require additional capital. As you acknowledge, one size does not fit all and banks utilize many risk mitigation techniques in extending ADC credit. As such, the Agencies should not ignore these risk mitigation techniques prior to assigning a capital charge. This is more appropriately executed at the field level by the Agencies examination staffs.

Because ADC loans are typically complex arrangements involving numerous risk mitigation techniques, it is difficult to envision a capital framework that could easily assign a reasonable capital charge without unduly burdening industry participants. The fairest approach should involve loan-to-value, borrower equity, pre-sale activity and demand factor considerations, which are all critical to ADC projects. This level of detail would be very burdensome to provide in a Call Report format. As a result, we believe that the risk-based capital framework currently captures the risk related to ADC credit, so long as the Agencies examination staffs are properly trained and diligent in there on-site reviews of banks' ADC lending practices.

Finally, we believe the Agencies should undertake a quantitative impact study to determine the impact of the proposal's implementation on minimum risk-based capital ratios, similar to those studies associated with Basel II implementation. This analysis would assist in the Agencies understanding of how the proposal may impact the general level of capital ratios and possibly reveal competitive inequities.

In order to better understand the regulatory burden associated with implementing this proposal, we believe the Agencies should also study the cost of implementing this proposal, as borne by the average institution. A firm understanding of the cost/benefit relationship is critical to understanding the burden borne by the industry.

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We appreciate the opportunity to comment on the Agencies capital proposal, and we hope that our comments are helpful and influential in the rulemaking process.

Sincerely,

Fremont Investment & Loan

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