January 18, 2006

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
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 & Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1238

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

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 Guidelines; Capital Maintenance: Domestic Capital Modifications

Dear Sir or Madam:

The Conference of State Bank Supervisors (CSBS) appreciates being made part of the process to modernize the risk based capital rules for domestic institutions. Given significant changes in the market place and enhanced risk management tools implemented by insured financial institutions, we agree with the goal of providing a capital scheme which enhances risk sensitivity. The challenge before us is to meet this goal without exponentially increasing the burden on domestic institutions or jeopardizing the safety and soundness of the banking system. A successful domestic capital framework will not only benefit individual financial institutions which effectively utilize risk management tools, but will also benefit the banking system as a whole by providing greater ability to effectively and efficiently manage capital.

State bank commissioners are pleased that the proposal does not alter the existing leverage capital requirements. We believe the current framework of requirements for both leveraged capital and risk based capital have served the system well. Maintaining express limits for leveraged capital provides an important and fundamental measurement of capital adequacy which preserves comparability of capital levels for bank supervisors and the investing public. This is especially true with respect to the rapidly changing market place and the evolution of financial products, as new products may not always be accurately slotted in the current risk based capital framework.

As you know, 70% of all bank charters are issued and actively supervised by state authorities. We believe in a strong supervisory role in determining capital adequacy. The proposal remains true to this

principle by addressing "minimum capital." Actual capital levels are best stipulated and judged by the agency issuing the charter.

The CSBS Regulatory Committee has a standing Basel Working Group, which is led by Dr. Katherine Wyatt of the New York State Banking Department. The group is responsible for addressing Basel II and Basel IA issues on behalf of the state banking system. Soon after the domestic capital framework was proposed, the group developed a "Basel IA Calculator." The product was designed to get an indication of the impact on minimum capital. The product was not designed to give a definitive or "right" answer, but to serve as a tool for thought and discussion. We are very pleased with its widespread use by state and federal bank regulators and the industry.

Impact of Basel IA on Capital Levels

The Agencies' Basel IA ANPR proposes broad changes in the way U.S. banks calculate minimum capital requirements for their portfolios. These revisions have been proposed against the backdrop of Basel II's revolutionary changes in capital regulations for the largest U.S. banks. Understanding the possible impact of the ANPR on minimum capital levels is crucial, but no public report of impact studies or tests has been released.

In a preliminary assessment of the ANPR's impact on capital levels, CSBS reviewed Call Report information at 6,065 FDIC-insured state-chartered institutions as of June 30, 2005. Of course, changes in a bank's capital requirement depend on the composition of its asset portfolio, as well as the details of the capital calculation. While the Call Report does provide information about banks' portfolio composition, it does not provide detail on Basel IA risk categories (LTV, external ratings, etc.). CSBS developed three "bank profiles" that cover a range of allocation into risk categories as proxies for this bank detail, and then estimated Basel IA risk-weighted assets at the state-chartered banks under these profiles. (See appendix for description of profiles and assumptions used.)

CSBS found significant changes in minimum capital requirements both on average and in aggregate when bank portfolios were analyzed using the proxy profiles --"conservative" (allocation into mostly low-risk categories), "custom" (allocation into typical or medium risk categories), and "aggressive" (allocation into higher risk categories). These profiles were applied to the following sub-portfolios[1]:

- residential real estate (including first lien, HELOCs, junior lien, and multifamily loans)
- performing wholesale loans and leases (excluding small business loans)
- performing small business loans
- performing land acquisition, development, and construction loans
- performing loans to consumers
- securities risk-weighted at 100% under Basel I
- unused commitments (not unconditionally cancelable) with original maturity under one year
- loans on non-accrual

We found that if our "typical (or custom)" profile were applied to all 6,065 state-chartered banks, minimum capital requirements would decrease on average by about 5%; minimum requirements would

[1] The Call Report does not identify collateral or guarantees, nor does it identify securitizations with early amortization features, so our assessment was unable to take these into account.

drop by about 15% if all banks were under the "conservative" profile; and minimum requirements would increase by about 17% if the "aggressive" profile were in effect at all banks. Clearly, state-chartered banks have adopted a variety of risk allocations, but these estimates do give an idea of the range of possible changes in minimum requirements. Better understanding of banks' actual risk allocations is essential.

Percent Change in Minimum Required Capital under Different Profiles[2]

	Custom	Conservative	Aggressive
Average	-4.8%	-14.8%	17.2%
Median	-5.2%	-14.5%	15.0%
Std.Dev.	9.3%	5.8%	11.3%
Max	27.2%	12.0%	177.7%
Min	-22.2%	-59.4%	-23.5%
Aggregate	-4.2%	-14.1%	18.4%

Under the assumptions of both the "conservative" and "custom" profiles, the contribution of Basel IA's lower risk weights for residential real estate, small business loans, consumer loans, and externally rated securities have greater effect than Basel IA's higher risk weights for acquisition, development, and construction loans, unused commitments with maturity under one year, and loans on non-accrual. The "aggressive" portfolio produces heavier risk weights for ADC loans, unused commitments with maturity under one year, and loans on non-accrual; these are more effective than the slight reductions in risk weight for the other sub-portfolios.

Our analysis falls short of an in-depth impact study, but it does give us an indication of the magnitude of possible changes. We think it is essential that banking supervisors conduct a more rigorous study once the detailed Basel IA proposal is available and before changes to capital requirements are implemented. We look forward to coordinating with the Federal banking regulators in advancing this assessment.

Basel IA: An Increase in Risk Sensitivity

Basel IA increases risk sensitivity by providing finer gradations of risk weights for the sub-portfolios it covers. These sub-portfolios, however, do not include all of a bank's assets, and the added risk sensitivity of the ANPR is limited by the lack of graded risk buckets proposed for commercial real estate other than ADC loans. The risk sensitivity is further limited by the little detail provided on risk-weighting for consumer, ADC, and small business loans, as well as loans on non-accrual. These gaps are important: when the actual portfolio shares of these exposures at the 6,000+ state-chartered banks are calculated, commercial real estate loans and small business loans make up a significant part of the banks' total assets. We feel that it is essential that the federal agencies provide sufficient detail on capital treatment for these sub-portfolios.

It is also important to note that anecdotal evidence suggests that providing additional risk weights for externally rated exposures or collateral will have little effect for non-Basel II banks, as few institutions make loans to borrowers with external ratings. External ratings are not available for most borrowers

[2] Two banks -- with 192% and 628% respectively of on-balance sheet assets in unused commitments under one year in original maturity -- were excluded from this analysis.

even at the largest Basel II banks -- it has been reported that only about 30% of Shared National Credits involve borrowers with public ratings.

Subportfolio Share of Total Assets

6,065 State-Chartered Banks	Average	Median	Std.Dev.
Residential real estate (first & junior liens, HELOCs, multifamily)	19.4%	17.1%	13.4%
Wholesale loans & leases (excluding small business)	16.9%	13.8%	14.5%
Small business loans[3]	15.6%	14.9%	12.5%
Nonfarm nonresidential real estate loans[4]	12.7%	12.1%	8.4%
Acquisition, development, and construction loans	6.3%	3.2%	8.2%
Consumer loans	5.3%	3.8%	6.8%
Securities with Basel I risk-weight of 100%	1.3%	0.6%	0.7%
Unused commitments with original maturity < 1 year[5]	0.7%	0.6%	0.7%
Loans on nonaccrual and past due 90 days or more	0.5%	0.3%	0.8%

Competitive Impact of Basel IA

One of the guiding principles behind development of Basel IA was to "mitigate material distortions in the amount of regulatory risk-based capital requirements for large and small institutions." The federal agencies have yet to release detailed comments on the results of QIS 4; the only information available for this exercise is preliminary data released as testimony during Congressional hearings. The reductions in minimum required capital reported by the QIS 4 institutions -- reductions of over 70% for residential real estate portfolios, for example -- are much greater than what we found. It seems unlikely that Basel IA will produce decreases in minimum required capital equivalent to Basel II's. However, we continue to be worried by the probable drop in minimum capital created by Basel II, and are concerned that the federal agencies will find it necessary to lower capital requirements for the non-Basel II banks to provide competitive equity.

Basel IA and Basel II banks do compete in many markets; the extent and character of this competition needs much more study if competitive equity is to be adequately addressed. From the preliminary data released on the QIS 4, it appears that the portfolio composition of the QIS 4 banks differs somewhat from that of the state-chartered banks we studied. However, portfolio shares are reported in terms of Basel I risk-weighted assets, which is less informative, perhaps, than shares of total assets.

Sub-portfolio Comparison with QIS 4 Banks: Share of Basel I Risk-Weighted Assets

	Aggregate State-Chartered Banks	Aggregate QIS 4 Banks
Residential Real Estate	16%	17%
Small Business Loans	13%	6%
ADC / HVCRE Loans	8%	1.8%
Consumer Loans	9.6%	12.1%

[3] Includes nonfarm nonresidential real estate loans under $1 million
[4] When small business loans are excluded, nonfarm nonresidential real estate loans account on average for 5% of total assets.
[5] Two banks -- with 192% and 628% respectively of on-balance sheet assets in unused commitments under one year in original maturity -- were excluded from this analysis.

The QIS 4 banks seem to have greater concentration in consumer exposures, while the state-chartered banks have larger shares of their portfolios in small business loans and acquisition, development, and construction loans. (High volatility commercial real estate loans in the Basel II framework are a subset of ADC loans.)

Competitive inequity is an issue of great importance, and because Basel II involves very different capital calculations from Basel IA (or Basel I) it is imperative that there be time to study the effects of these proposals side by side -- with sufficient detail provided -- before either is adopted.

The following areas will address the specific areas of the proposal.

Increased Number of Risk Weight Categories
The additional risk weights provide the opportunity for enhanced risk definition. The appropriateness of particular weights will be more easily determined as more specifics are developed.

Use of External Credit Ratings
Based on the type of lending activity conducted at the majority of financial institutions which will be impacted by this proposal, the use of external credit ratings for risk weighting will have a minimal impact. We are concerned, however, that reliance on external ratings is an abdication of regulatory responsibility.

Expand Recognized Financial Collateral
We are concerned with extending lower risk weights based solely on the type of collateral. This may lead to credit allocation by benefiting borrowers with "highly desirable" collateral. The capital framework should not drive banks into loans with "less risk" where they do not possess proficiency and away from loans with "greater risk" where the bank possesses a great deal of proficiency. We should strive for a holistic loan risk weighting system which includes underwriting criteria and risk drivers beyond collateral protection.

One to Four Family Mortgages
Loan-to-value (LTV) is an appropriate risk driver in one-to-four family mortgage lending. The proposed LTV ranges and risk weights appear reasonable. The rule should permit banks to update the LTV annually based on principal performance. The rule should also include a mechanism to require an LTV update in cases of significant declines in market values in the bank's service area.

We are concerned with the disparate treatment of second mortgage residential loans where the bank does not retain the first mortgage. This weighting appears to penalize common industry practice. While the penalty itself possesses logical inconsistencies, our deep concern is that the penalty will be borne by consumers. At worst, its impact may result in contraction of credit availability for consumers. At best, it will certainly increase borrowing costs for consumers on a basic credit product which has played a significant role in fueling our economic recovery.

In addition to LTV, we support the use of credit scores as part of a risk weight matrix. Credit scores are a commonly used risk driver utilized in the underwriting process. An LTV / credit score matrix would

appropriately factor in collateral and credit history in determining capital support. The matrix approach would also accommodate a wider variety of lending programs, allowing banks to meet the particular credit needs in their communities. Since credit scores are an important factor in making the credit decision and performance is the key factor after origination, we see little value in updating credit scores without an event necessitating a modification to the facility.

Most nontraditional mortgage products should work well within the LTV / credit score matrix. Mortgage loans with the potential for negative amortization should be evaluated according to the potential balance.

While banks acquire LTV and credit scores at origination, in many cases they have not been including it when the loan is entered into the computer system. Given this fact, we believe that loans originated before the final rule should be weighted through a portfolio assessment rather than loan-by-loan. This will relieve the industry of having to recode each loan in their computer system.

Multifamily Residential Mortgages
The capital treatment for multifamily residential mortgages should be similar to commercial real estate loans. Our views on this topic are detailed below.

Short-Term Commitments
We support a credit conversion factor (CCF) on commitments with an original maturity of one year or less. To ease burden and create a simplistic scheme, we support a single CCF of 20% for both short and long-term commitments.

Loans 90 Days or More Past-Due or in Non-accrual
We support the idea of higher risk weights for non-current loans. However, the framework needs to provide for additional adjustments beyond allocated reserves. A loan which is well secured would not necessarily increase the likelihood of loss simply because it is delinquent. We would suggest an exemption for loans which qualified for a lower risk under any loan-to-value criteria.

Commercial Real Estate Exposures
The proposal cites the need to revise the capital requirements for certain commercial real estate exposures based on "longstanding supervisory concerns." As bank supervisors on the front lines, we appreciate these concerns. The specific product type referred to in the proposal is acquisition, development, and construction (ADC) loans. By referencing the Interagency Real Estate Lending Standards as a qualifier for exemption from a higher capital charge, the proposal appropriately acknowledges that risk is often created by the manner in which ADC loans are conducted. The second requirement is support "by a substantial amount of borrower equity for the duration of the facility." We are concerned that this approach is too narrow and will not adequately capture the different types of commercial real estate loans and risk mitigation techniques used by financial institutions.

In order to achieve appropriate risk weighting of CRE exposures, we need more granularities applied to the term "commercial real estate." There is a significant difference in underwriting, risk drivers and lender expertise for different types of CRE loans. We believe it is a worthwhile goal to develop a risk weighting scheme for CRE exposures. We remain very concerned with unintended consequences in the marketplace and its disproportionate impact on the availability and cost of credit for small businesses.

We strongly believe that any capital framework for CRE exposures should benefit those institutions which understand and manage the risk, while at the same time encouraging other institutions to sharpen their underwriting and risk mitigation practices.

Given the potential impact on thousands of financial institutions and the market place, we believe this area deserves additional study. The Conference of State Bank Supervisors is willing to sponsor a working group of regulators, industry, and lending experts to develop a risk weighting framework for CRE exposures which will protect the safety and soundness of the banking system and meet the market needs of insured financial institutions.

Small Business Loans
The proposal takes a reasonable approach in terms of amortization period, collateral protection, and underwriting policies. Given potential concentrations in this area, the framework should provide a percentage limit on loans which can qualify for this treatment. The agencies should also include a regulatory caveat which could be used to void this provision for any lack of required expertise discovered during the supervisory process.

Implementation
CSBS supports developing a framework with enhanced risk sensitivity and the overall direction of the proposal. As the proposed rule is drafted, the federal banking regulators need to have representatives from state banking authorities at the table. State regulators serve as the primary regulator for the vast majority of institutions which will be impacted by this rule. Their local view and experience will contribute greatly to the process.
We firmly believe that the current rules should largely remain in place for institutions which desire that framework. Our Basel working group thoroughly discussed the criteria for a bank to remain under the current rules. We concluded that the bank should be able to make this decision based on market needs or demands. Undoubtedly, under such a framework, the bank's primary regulator would be able to mandate compliance with the revised rules through the supervisory process. A bank which converts to the revised framework should be prohibited from switching back for three to five years.

The proposed capital rule for large, internationally active banks (Basel II) is expected in the next few months. We strongly suggest that the Basel II comment period be sufficient to ensure a lengthy overlap with the domestic proposal. The industry and the market deserve the opportunity to view these proposals side-by-side.

Best regards,

Neil Milner, CAE
President & CEO

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Appendix. Estimation methods.

Estimates of changes in minimum capital requirements under Basel II were made using templates developed by state regulators and the staff of the Conference of State Bank Supervisors. These templates use June 30 Call Report information on risk-weighted assets (Schedule RC-R), loans and leases (Schedule RC-C), loans on non-accrual (RC-N), and unused commitments (RC-L) to estimate assets in the particular categories affected by the ANPR. A full description of the custom spreadsheets can be found on the CSBS website (www.csbs.org).

CSBS developed three "profiles" of bank portfolio credit quality -- custom (or typical), conservative, and aggressive -- with varying percentage allocations in ANPR risk categories. Minimum capital under the provisions of the ANPR was then estimated using bank assets from the Call Report for each of the credit quality profiles. These estimates were compared with minimum capital requirements under Basel I (or current) risk weights.

Certain simplifying assumptions were necessary to carry out this exercise:

- Unused commitments for credit card lines and HELOCs are unconditionally cancelable by the bank.
- Risk-weighting for "other loans" (RC-C 9) and "other assets" will not be affected under Basel IA.
- Only loans on non-accrual are risk-weighted in the Basel IA estimates, rather than the sum of loans on non-accrual and loans past due 90 days or more, to take possible specific reserves into account.
- A 35% risk weight bucket will be proposed for multifamily loans that are currently risk-weighted at 50%.
- The risk weights for loans on non-accrual will be either 100%, 150%, or 200%.
- Available risk weights for acquisition, development, and construction loans will be 100%, 150%, 200%, or 350% buckets.
- Risk weight buckets for consumer loans will be 50%, 75%, 100%, or 150%.
- Small business loans are defined as the sum of total outstanding commercial and industrial loans under $1 million and total outstanding loans under $1 million that are secured by nonfarm nonresidential properties, as reported on the June 30, 2005, Call Report, Schedule RC-C Part II.

Guarantees, collateral, or early amortization features of securitizations were not considered in this estimation process.