Guaranty BANK
a Temple-Inland company

January 18, 2006

Regulation Comments, Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: No. 2005-40
VIA email: reg.comments@ots.treas.gov

RE: RIN 1550-AB98: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications -- Joint ANPR (No. 2005-40)

Ladies and Gentlemen:

We appreciate the opportunity to comment on the potential revisions to the domestic risk-based capital rules as outlined in the Joint Advanced Notice of Proposed Rulemaking ("ANPR") No. 2005-40. Many of the risk-based capital rules under review relate directly to our business lines, and have the potential to greatly influence our activities in those areas. Our commentary below will hopefully take into consideration the practical aspects of rule changes, since there is a justifiable concern over the potential incremental costs and administrative burden relating to the implementation of a refined capital regime for banks of all sizes, unrelated to the underlying "economic" soundness of the proposal. (While we will use the term "bank" or "banks" below, our comments will generally apply to banks, bank holding companies, and thrifts interchangeably.)

Mortgage Warehouse Lending should be considered for reduced risk-weighting

One omission from the ANPR that we believe worthy of consideration (and consistent with its stated purposes) is a re-evaluation of the 100% risk-weighting currently applied to mortgage warehouse lines. Mortgage warehouse lines are collateralized predominantly with assets that the ANPR acknowledges have relatively low risk, and generally are funded at a haircut to the collateral amounts. As a result, we believe it would be appropriate to risk-weight mortgage warehouse lines at an amount lower than uncollateralized commercial lines. We note that the current adverse risk-weighting for these assets has resulted in a situation where a number of institutions have undertaken securitization transactions at significant costs in order to obtain more favorable capital treatment (while, in general, retaining essentially the same credit risks as

before the securitization – i.e., other than the reduced capital charge, these transaction may be uneconomic).

We are not trying to make a case that extending credit to a mortgage originator and collateralizing that extension of credit with the specific mortgages the originator holds is the "economic" equivalent to directly funding the mortgage loans; however, discussion in the ANPR relating to "financial collateral" tacitly acknowledges that collateral matters, and that credit quality differentiation among collateral types is relevant. We note that if a warehouse lender were to take ownership of the collateral and decide to retain it rather than liquidating it (since the loans are generally acceptable assets for investment), the collateral would immediately be subject to the lower risk-weighting proposed in the ANPR.

Collateral in a warehousing context "turns over" rapidly versus collateral usage in most other loan types. As a result, there is less time on average for a diminution of credit quality. Additionally, warehouse collateral tends to be very recent originations, a phase where mortgage collateral tends to perform even more favorably from a credit standpoint than over its life. Finally, the secondary market for whole mortgages has developed and matured dramatically over the past two decades such that sufficient liquidity exists for a warehouse lender to readily dispose of mortgage collateral if necessary (in fact, warehoused mortgage loans are often accompanied by forward sale or other hedging arrangements by the warehouse borrower).

As a practical matter, it may be operationally burdensome to track the credit dimensions of <u>each</u> mortgage loan backing a warehouse line, assuming that the risk weight assigned to the <u>direct</u> holding of mortgages is differentiated by LTV, credit score, etc., as is suggested in the ANPR, and is applied at the individual loan level. Difficulty tracking individual loans is particularly likely since the collateral pool will tend to "churn" rapidly. Because of these factors, we don't recommend a loan level collateral assessment for risk-weighting the warehouse line, but advocate the risk-weighting of warehouse lines reflect the substance of the collateral such that, for example, a 50% risk-weighting is applied.

<u>One-to-four family mortgages typically justify much lower capital treatment; LTV and credit scores are helpful, though have limitations; MBS risk weighting should be lower than that assigned to mortgage loans</u>

We believe the risk-weighting of first-lien mortgages can be improved by considering indicators of credit risk. The current 50% weighting is too high for a "typical" mortgage based on the various studies on mortgage risk and the proposed treatment under Basel II. We strongly endorse the concept of risk-weighting based on objective credit parameters. The problem, of course, is in finding the optimal mix of parameters, "weighting" them correctly, and mapping to the appropriate risk-weight category. We will point out that most potential credit variables are being captured in the loan origination process already (though not in the quarterly regulatory filings), so we don't think it would be excessively burdensome to consider these variables in risk-weighting. It would, however, be burdensome to update these credit variables in the future –

for example to obtain a new LTV a year later based on a change in the property value as well as loan amortization, or to obtain an updated DTI.

The ANPR uses LTV as an example of a credit dimension that could be used to differentiate credit risk among mortgages. While LTV is universally accepted as a credit variable, we think LTV's explanatory power is limited to the extent that lenders "trade off" LTV against other credit variables in determining whether to extend credit and/or how it should be priced (for example, a higher LTV is acceptable if the borrower has a higher credit score, all else held equal).

A "credit score" is invariably mentioned as a key credit criterion that, when combined with LTV, may have significant predictive qualities, and "credit score" is used almost interchangeably these days with "FICO." We point out that, although it is relatively easy (though not without cost) to obtain updated credit scores, there is no official sanctioning of FICO scoring (as there is with an NRSRO designation) and, if "credit score" is a key credit variable used in the determination of risk-weightings, the regulation should be written flexibly to allow for alternative credit scoring schemes, and even a potential change in the way any particular FICO score should be interpreted. In other words, a 720 FICO may have different risk implications in the future than it has today, based on changes Fair Isaac makes to its methodologies (such as the potential to incorporate income aspects into scores). In fact, in the future, FICOs might be replaced as the market "standard" by another scoring methodology provided by another vendor, or even that of a government or government agency (not unlike how the mortgage GSEs established a mortgage underwriting benchmark).

We endorse the inclusion of loan-level PMI in the risk-weighting methodology, though we stress that PMI impacts loss-given-default but not the probability of default. As such, an LTV inclusive of PMI has different explanatory power from the same LTV without PMI, and perhaps the risk-weighting methodology should capture this, if making that distinction is not overly burdensome. We also advocate the recognition of pool-level PMI, with adjustments made for carve-outs and exceptions and "deductibles" (i.e., mezzanine-level protection). The credit quality of PMI providers should also be factored in.

We are opposed to a differentiated capital treatment for "non-traditional" mortgage products, because of the difficulty in crafting a definition that would capture products with higher credit risk but not penalize those same products underwritten conservatively, and because of the constantly changing universe of products to which the definition would have to apply. As with any product line, inside or outside financial services, innovation is not only commonplace, but necessary, as the wants and needs of consumers evolve. A differentiated capital treatment would almost always be "playing catch-up" with the market. It is noteworthy that a generic adjustable rate mortgage was "non-traditional" a quarter century ago. A hybrid mortgage was "non-traditional" less than a decade ago. In fact, negative amortization has been around for at least 25 years. If regulators believe loans with negative amortization have become more "risky" in recent years, then it is arguably attributable to bad underwriting, not the negative amortization feature

itself. We believe the criteria used to risk-weight more traditional mortgages (LTV, credit score, etc.) would capture the incremental risk in non-traditional products (particularly if the LTV on negative amortizing loans, for underwriting purposes, is assumed to be at the negative amortization cap, for example). The recently proposed supervisory guidance on non-traditional mortgages outlines underwriting characteristics that can be monitored through supervisory guidance on an institution-specific basis. This approach is superior to the imposition of a punitive, across-the-board capital treatment.

The current differences between the capital requirements of depository institutions and those of the GSE's creates an environment significantly advantageous to the GSE's. A more rigorous regulatory regime for the GSEs (which we support) is likely to strengthen the widespread perception of government backing, further increasing the GSE's competitive advantage. Reducing the capital requirements on mortgages will help to level the playing field, furthering the ability of depository institutions to continue to make mortgage funding available.

With respect to second-lien positions, we don't dispute that second-liens can be riskier than first-liens, and that a 90% CLTV is probably a reasonable "trip-wire" for a higher risk-weighting than a first-lien exposure. However, it seems inconsistent for the risk-weighting on a collateralized second-lien obligation to be potentially equal to or higher than that of unsecured consumer paper, as proposed in the ANPR. We would propose that a maximum 100% risk-weighting be retained for all second-lien exposures.

Finally, we also point out that many financial institutions hold mortgage-backed securities ("MBS") as an alternative to whole loans. Agency MBS and Non-Agency MBS rated AA or better are currently assigned a lower risk weighting than single family mortgage loans. We believe this is appropriate, due to their relative advantages from a credit and liquidity perspective. Therefore, we believe that if the risk-weighting of mortgages held in whole loan form is to be lowered, MBS weighting should also be recalibrated, to capture the innate benefits of the securitized format.

Short-term commitments warrant capital, support assignment of 20% conversion factor to short and long-term commitments

We believe that short-term commitments should be converted at a conversion factor greater than zero. We also believe that longer-term commitments warrant a somewhat higher conversion factor than short-term commitments. We do not, however, believe the risk differential warrants significantly disparate treatments between short-term and longer-term commitments (for example, the 10% assignment contemplated within the ANPR for short-term commitments compared to the 50% assignment currently utilized for longer-term commitments). Accordingly, of the options suggested in the ANPR, we support assignment of a 20% conversion rate for both short-term and longer-term commitments.

Expand eligible guarantors

We strongly endorse expanding guarantor eligibility. Banks commonly consider guarantees from creditworthy guarantors as significant enhancements to credit quality, particularly in CRE transactions. Where a guarantee is from a rated entity, we concur with considering the guarantor only when the entity is rated investment grade, and differentiating the risk-weighting of the guaranteed obligation based on the credit rating of the guarantor. Additionally, we propose the agencies consider the significant credit enhancement that guarantees from some unrated entities such as pension funds can provide, and reflect that risk mitigation with reduced risk-weighting.

Adequately underwritten CRE loans do not require higher risk-weighting

We are opposed to increasing risk-weightings to levels above 100% on performing CRE loans. CRE underwriting and lending is much more disciplined than it has been in the past and industry loss experience has shown that, if loans are underwritten in accordance with the Interagency Real Estate Lending Standards, credit risk on ADC transactions is not unusually high. We believe CRE risk-weightings (for ADC loans) should differentiate by LTV. If a property does not perform once developed (or if the borrower does not complete the property), the amount of equity in the project is often the primary factor in whether the lender takes a loss on the loan. However, we also believe other underwriting characteristics like property-type, developer experience, guarantors, and covenants are important.

We believe the term "equity" used in the CRE section of the ANPR should include as-is appraised value of property contributed to a borrower in addition to "cash" equity. Many ADC transactions involve construction on land that has been acquired and held by a principal – often that land has appreciated in value considerably before the ADC loan is undertaken, lowering the effective LTV and the lender's risk.

There are also many other arrangements in the ADC market that provide the lender equal or better protection than 15% cash equity, which we believe should be considered in risk-weighting CRE exposures. For example, it is commonplace in ADC lending for a "take-out" or pre-negotiated sale arrangement to be in place. We believe this is a form of credit enhancement very similar to a guarantor relationship (when not limited by collateral performance contingencies). If the take-out counterparty is a rated entity, such as an insurance company with a Best rating, we believe the rating should be factored into the risk-weighting. However, the provider of the take-out is very often an unrated entity – such as an endowment or pension fund – unrated because it has no need for debt. For these entities, we believe criteria can be developed to objectively differentiate the credit quality of such a take-out counterparty in a manner that can be captured in a refined risk-weighting scheme.

Expand lower risk-weight application to more multifamily mortgages

We believe the criteria used to grant preferential treatment to seasoned multifamily mortgages should be extended to all multifamily mortgages that have collateral producing cash flow sufficient to service the debt. Additionally we believe those criteria could be improved, particularly the rules relating to minimum maturity, LTVs, cash-flow look-back periods, and principal payment "seasoning" requirements. The GSE's become have increasingly active lenders in the multifamily market and the existing rules result in a competitive disadvantage for depository institutions.

The existing qualifying multifamily mortgage loan ("QMML") rules limit 50% risk-weighting to assets with at least a seven-year maturity (a lower risk-weighting for a longer maturity). We note the proposal in the ANPR under Small Business Loans is for a lower risk-weighting when a loan has a maturity shorter than seven years. Additionally, "economic" capital models (employed by "Basel II" banks) tend to assign a higher risk-weight to longer maturities. As a result, we recommend the minimum maturity limitations be removed from the multifamily risk-weighting rules.

The existing QMML rules allow 50% risk-weighting at different LTV levels, depending on whether the loan is variable-rate or fixed-rate. Neither the existing one-to-four mortgage rules, nor those proposed in the ANPR differentiate on LTV. We recommend that LTV considerations on multifamily risk-weighting be the same regardless of the interest rate characteristics of the loan. We also note that non-depository lenders are generally willing to lend on cash-flowing collateral up to 80% LTV, limiting depository institutions' ability to compete for variable-rate loans under the existing QMML rules because the rules for variable-rate loans require 75% or lower LTV.

For new loans (as opposed to refinance transactions), the existing QMML rules require the underlying property to have produced cash flow at the specified level for the property's most recent fiscal year. Multifamily borrowers are typically required to submit operating statements monthly, therefore it is relatively easy for lenders to determine on a timely basis whether a property is generating sufficient cash flow. As a result, we recommend the rules use a rolling 12 month look-back period rather than a fiscal year period. Additionally, we note the required level of cash flow for fixed-rate loans to qualify under the existing QMML rules is higher than the required level for variable-rate loans (120% compared to 115%). From a cash flow coverage standpoint, there is less risk with a fixed-rate loan; however, considering the insignificant difference between the two requirements, we recommend the coverage levels be the same regardless of interest rate characteristics of the loan.

Finally, we believe the principal payment characteristics of a multifamily loan, particularly early in its life, are not very relevant to the credit risk of the asset. The existing QMML rules only allow favorable capital treatment for loans that have paid principal for one year. We recommend allowing favorable capital treatment regardless of the principal amortization characteristics as

long as the underlying collateral is producing cash flow at a level that would support amortizing principal payments.

Expand eligible collateral to include tangible non-financial collateral

We endorse expanding the list of recognized eligible financial collateral. We also believe "hard" collateral (such as oil and gas reserves, capital equipment, etc.) should be more broadly captured in the risk-weighting scheme. While we recognize the obvious relative advantages of "financial" collateral as described in the ANPR (liquidity, transferability, fungibility, etc.), we note that the ANPR considers the relevance of collateral when evaluating capital for small-business loans – we see no reason to limit it to loan size. Continuing to risk-weight loans with supportable tangible collateral the same as uncollateralized loans seems inconsistent with the ANPR's objectives. The capital regulations would have to draw parameters around the use of hard collateral, and the necessary data capture and maintenance would be somewhat burdensome, especially for smaller depositories, however we see a fundamental inconsistency in the capital regulations if hard collateral is completely ignored, in areas other than mortgages.

Use of external credit ratings appropriate, but suggested risk-weightings too onerous for below investment grade credits

We concur with the concept of mapping credit ratings to specific risk weights. The potential for increased regulatory oversight of NRSROs legitimizes the rating agencies' role in the depository regulatory regime. However we believe the specific mapping scheme proposed in the ANPR is generally too onerous, particularly relative to how much "economic" capital is being allocated to investment grade credits by Basel II banks. Part of the motive for the ANPR in the first place is to minimize the likely competitive disadvantages of non-Basel II banks, so the revised risk-weighting should be better aligned with what Basel II banks are likely to use.

We also note a significant distinction between the suggested risk-weighting for B and BB credits compared to the risk-weight of unrated obligations. A review of Moody's syndicated credits indicates an average rating of Ba3, which is analogous to a BB- using the rating system in the ANPR. We believe an "outlier" risk-weight, such as the 350% suggested in the ANPR, should be reserved for nonperforming assets. In other words, an asset that has degenerated in quality may end up at a 350% risk-weighting, but no asset starts out at that level at the time it is acquired.

It is our understanding that the intent in the ANPR is for both rated loans and rated bonds to be treated similarly. Assuming the proposal applies to loans, we recommend also mapping any unrated obligations to the risk-weighting applicable to the rated obligations of the same borrower, if it can be readily proven that the unrated obligation is at least pari passu in the capital structure with the equivalently-rated obligation. We observe that, with respect to the use of guarantors, the ANPR suggests using the senior unsecured debt rating of the guarantor as a proxy for credit rating, even though the guarantee itself wouldn't likely be rated.

Expand scope of small business proposal to include more borrowers/loans

We think many of the changes proposed in the ANPR will naturally "extend" to the benefit of small business lending (for example, consideration of collateral and guarantors in risk-weighting). We advocate further extension of the ANPR's consideration of small business loans beyond the suggested $1 million amount. HOLA contains guidance regarding small business loans and we believe consistency between HOLA and the capital rules would be appropriate. Therefore, we recommend differentiated treatment for loans under $2 million.

It appears that the ANPR is recommending either a 100% risk-weighting or a 75% risk-weighting for small business loans. Even without the possible capital benefits of collateral and guarantors, we believe there is the potential for even more refined granularity beyond those two discrete levels, given the wide range of industries that can qualify as "small businesses." For example, we believe there is potential for additional maturity granularity instead of a discrete seven-year break point (and the regulations will have to be clear on whether specific maturity buckets mean full amortization to that maturity date, or slower amortization plus a balloon payment on that maturity date).

Finally, it would be helpful to have clarification of what is intended in the ANPR by the reference to the banking organization underwriting a loan "according to its underwriting policies". We note that lending policies generally allow for exceptions to certain aspects of the standard requirements if a loan has compensating credit characteristics.

Treatment of cash secured loans inconsistent across agencies

In the interest of aligning risk-weightings across depository institutions with different supervisory charters, we point out an inconsistency in the treatment of cash-secured loans. The capital requirements for such loans differ between thrifts and banks, in that the OTS ascribes a 20% risk-weighting to loans fully collateralized by deposits (and does not differentiate deposits held at the reporting bank from deposits held at another bank), while OCC regulations permit (under certain circumstances) a 0% risk-weighting if the deposits are held at the reporting bank, with higher risk-weighting if the deposits are held at another bank. We recommend this inconsistency be removed.

Application and transition – be consistent, and limit transitional floors

Because the suggestions in the ANPR reflect improved recognition of credit risk in capital requirements, it seems inappropriate to allow an individual institution to pick-and-choose among the refinements that result from this ANPR. While we acknowledge that these proposals, if and when implemented, will vary in the degree to which they impose a burden on individual depositories, we think this concern should be outweighed by the desire we all have to make

depositories better risk managers and to close "capital arbitrage" loopholes. Additionally, we believe a bank holding company should be required to determine capital requirements across all of its subsidiary banks uniformly under the same capital regime to prevent capital arbitrage by strategically transferring assets across charters, which might increase risk at the individual subsidiary banks.

We also recommend the implementation of the risk-weighting guidelines emanating from this ANPR not necessarily be aligned with the implementation of Basel II guidelines. Because these potential changes better reflect the risk of the associated assets, we recommend implementation as soon as the rules become finalized. And, while we understand the need for a transition phase for the implementation of Basel II (especially in light of the QIS4 results), we don't think the changes in the capital regulations resulting from this ANPR need to pass through an extensive transition period. We suspect that most of the changes to banks' risk-capital requirements can be readily determined, since the intent is to utilize information that is already being captured (though maybe not on the current version of the TFR/Call Report).

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If you have any questions regarding our comments, please contact me at 1300 S. Mopac, Austin, Texas 78746, Attn: Michael Calcote or by phone at (512) 434-1086.

Sincerely,

/s/ Mike Calcote

Chief Financial Officer, Guaranty Bank

cc: Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation