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January 13, 2006

Public Information Room
Office of the Comptroller of the Currency
250 E Street, SW
Mailstop 1-5
Washington, DC 20219
November 9, 2005

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 an 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

Dear Sir or Madam: The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer comments on the Advanced Notice of

[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 17,000 locations nationwide and employing over 260,000 Americans, ICBA members hold more than $631 billion in insured deposits, $778 billion in assets and more than $493 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

Proposed Rulemaking (ANPR) issued by the banking agencies and published in the *Federal Register* on October 20, 2005 regarding potential revisions to the current U.S. risk-based capital rules for banking organizations, known as the Basel I capital rules. The ANPR seeks comment on various changes to the Basel I capital rules including increasing the number of risk-weight categories, permitting greater use of external ratings as an indicator of credit risk for externally-rated exposures, and modifying the risk weights associated with residential mortgages, certain small business loans and other bank assets.

Summary of ICBA's Position

ICBA generally supports the contemplated revisions to the Basel I capital rules provided that the new rules have an opt-out provision that would give highly capitalized community banks the option to continue using the existing risk-based capital rules. ICBA has long advocated revising Basel I to make it more risk sensitive and to help address competitive issues with using a bifurcated capital system. ICBA supports the ANPR's proposal to add four more risk categories to the Basel I rules to enhance their risk-sensitivity and to align capital requirements with risk levels. Additional weight categories over the four that have been proposed would unduly complicate the task of computing risk-based capital for a community bank or holding company.

External Credit Ratings. ICBA also agrees with the concept of using external credit ratings to enhance the risk-sensitivity of Basel I and supports the use of the proposed risk weight categories for categorizing rated investment securities as illustrated in Tables 1 and 2 of the ANPR. ICBA agrees with the agencies that the current zero percent risk weight for short- and long-term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government should be retained as well as the 20 percent risk weight for U.S. government-sponsored entities and for general obligation municipal securities.

Residential Mortgages. As for one-to-four family residential mortgage loans, **ICBA endorses the proposal to add additional risk weights (e.g., a 20 percent and 35 percent category) for assessing a bank's one-to-four family mortgage portfolio and to base those risk weights on loan-to-value ratios as illustrated in Table 3 of the ANPR.** If risk-weights are based on LTV ratios, we would recommend that a mortgage loan LTV ratio be determined at the time the mortgage is originated and that banking institutions have the flexibility of changing or updating the risk weights of their mortgage loans as normal principal payments are made and/or as the LTV ratios change. While we acknowledge that pairing credit scores with LTV ratios might enhance the risk sensitivity of the mortgage loan risk weight categories, we feel it may be more a regulatory burden than a benefit to include credit scores with LTV ratios.

ADC Loans, With respect to certain acquisition, development and construction loans that do not conform with Interagency Real Estate Lending

Regulations, **we are concerned about lumping them all into one risk-weight category and support further study to determine the appropriate risk weight categories**.

Small Business Loans. As for small business loans, **ICBA recommends that the agencies establish a 75 percent risk weight category for those small business loans that are under $2 million and that are (1) fully collateralized (2) amortizable over a period of 10 years or less, and (3) have been originated consistent with the banking organization's underwriting policies.**

Opt-Out for Highly Capitalized Banks. **ICBA strongly recommends that the agencies adopt an "opt-out provision" as part of a revised Basel I that would give highly capitalized community banks the option to continue using the existing risk-based capital rules and avoid the regulatory burden of more complex risk-based capital rules**. This opt-out provision could be limited to community banks with under $5 billion in assets that have capital-to-asset leverage ratios of 7 percent or higher.

Quantitative Impact Study. **ICBA also strongly recommends that the agencies conduct a quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a revised Basel I.** ICBA strongly supports the decision by the agencies to maintain the capital-to-assets leverage ratio requirement for all banks, including Basel II banks and also agrees that the Basel II banks should be subject to floors during their three- year transitional period. We would suggest that the floors be a percentage of the risk-based capital for those banks calculated in accordance with the original Basel I rules, not the proposed Basel 1A rules.

Background of the Basel I Proposed Revisions

Adopted in 1989, the current U.S. risk-based capitals rules are based on the "International Convergence of Capital Measurement and Capital Standards" which is known as Basel I. Under the Basel I framework, banking organizations are required to assign balance sheet exposures to one of five categories of credit risk, which carry minimum capital charges ranging from zero to eight percent. Almost all exposures to individuals and companies, other than residential mortgages, are assigned to the standard risk weight category (i.e., the 100 percent risk weight category), limiting the extent to which the Basel I rules recognize risk differentials among different credit exposures.

In response to concerns that Basel I was not sufficiently risk-sensitive for many exposures held by the large banking institutions, the Basel Committee on Banking Supervision launched an effort to fundamentally revise Basel I. These efforts culminated in the Committee's release in June 2004 of a revised capital

framework known as Basel II. The banking agencies also released an advance notice of proposed rulemaking for the implementation of Basel II in the United States which indicated that Basel II would be mandatory for only the largest U.S. banking organizations with total assets of $250 billion or more or total on-balance sheet foreign exposure of $10 billion or more. Other institutions would have the opportunity to opt-in to Basel II provided they meet very strict eligibility standards. ICBA commented on the Basel II ANPR and expressed our concerns about the complexity of Basel II and the competitive inequities that would result if Basel II were implemented. ICBA also recommended further changes to Basel I to make that accord more risk-sensitive and address the competitive inequities presented by Basel II.

To assist in quantifying the potential effects of Basel II, the Agencies conducted a quantitative impact study during late 2004 and early 2005 (QIS 4). QIS 4 was a comprehensive effort completed by 26 of the largest banking organizations using their own internal estimates of the key risk parameters driving the capital requirements under the Basel II framework. Preliminary results of QIS 4 prompted concerns about the reduced levels of regulatory capital that would be required at individual banking organizations operating under the Basel II rules.

On September 30, 2005, the agencies announced a revised timetable for the implementation of Basel II. Under this revised timeline, the first opportunity for a U.S. banking institution to conduct a parallel run would be January 2008. In addition, U.S. institutions adopting the Basel II capital rules would be subject to a minimum three-year transition period beginning 2009 during which the agencies would apply limits or floors on the amount by which each institution's minimum capital requirement could decline with the application of Basel II. The agencies also said that they would retain the current Prompt Corrective Action and leverage capital requirements in the proposed domestic implementation of Basel II.

In a recent statement to the Senate Banking Committee[2], ICBA commended the agencies for their revised timetable for Basel II implementation but expressed concerns that Basel II will place community banks at a competitive disadvantage. ICBA noted that the results of QIS 4 confirmed that Basel II would yield lower capital charges for residential mortgage, retail and small business loans for Basel II adopters, the very credits where community banks compete with large institutions. For residential mortgage credits, QIS 4 results showed that minimum capital requirements for Basel II adopters would drop an average of 73% for residential mortgage loans and 79% for home equity loans.

ICBA also fears that Basel II will further accelerate the consolidation in the banking industry. Lower minimum capital requirements that large banks obtain under Basel II will likely result in more acquisitions by larger banks seeking to

[2] See Statement of ICBA on "The Development of New Basel Accords" before the Committee on Banking, Housing, and Urban Affairs of the United States Senate dated November 10, 2005.

lever capital efficiencies or obtain the scale to justify opting in to Basel II. As more of the larger banks opt-in over the time to obtain the competitive advantages of Basel II, the viability of community banking may eventually be threatened. Since community banks will remain under Basel I, they will have difficulty competing against bigger Basel II banks that benefit from reduced capital requirements and higher returns on equity. Basel I banks will become likely takeover targets for Basel II banks that believe they can deploy Basel I bank capital more efficiently. As more Basel I banks are left with riskier assets, lower credit ratings and higher costs of liabilities, they will find it more difficult to compete for the higher quality assets, exacerbating the competitive inequalities flowing from Basel II.

The agencies are now proposing to revise Basel I not only to update the risk-based capital standards to enhance the risk-sensitivity of capital charges, but also to address competitive equity questions raised by U.S. implementation of the Basel II framework.

ICBA's Specific Comments Regarding the ANPR

Increasing the Number of Risk-Weight Categories

As noted above, ICBA supports adding additional risk-weight categories to the Basel I risk-based capital rules to enhance their risk-sensitivity and to align capital requirements with risk levels. However, the revisions should not be so complicated that computing risk-based capital becomes an undue regulatory burden for banks. As one community banker put it, "We don't want the risk-based capital rules to become the regulatory burden that the Call Report has become." **ICBA therefore recommends that only the four risk-weight categories that have been proposed--35, 75, and 150 and 350 percent—should be added to the five categories already in existence—zero, 20, 50, 100, and 200 percent.** Additional risk weight categories over these nine would only unduly complicate the task of computing risk-based capital for a community bank or holding company.

Use of External Credit Ratings

ICBA generally agrees with the concept of using external credit ratings to enhance the risk-sensitivity of the Basel I risk-based capital rules. Using the external credit ratings that are publicly issued by the Nationally Recognized Statistical Rating Organizations (NRSROs) to assign risk weights for securities held by banks is a reasonable approach to assessing the risk exposure of a bank's securities portfolio. Furthermore, the risk-weight categories in Tables 1 and 2 of the ANPR are an appropriate way to assess securities portfolios without imposing a regulatory burden on community banks.

ICBA agrees that the current zero percent risk weight for short- and long-term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government should be retained as well as the 20 percent risk weight for U.S. government-sponsored entities. The current risk-weights for all general obligation municipals (e.g., 20 percent) and for all municipal revenue bonds (e.g., 50 percent) should also be retained.

For the great majority of community banks that invest most of their securities portfolio in either U.S. government and agency securities or municipal securities, using external credit ratings to assess the risk exposure of their securities portfolio will not have much impact on their overall risk-based capital ratios. However, ICBA believes that as long as the approach is not overly complicated, many community banks will find a more risk sensitive assessment of their securities portfolio to be beneficial.

One-to-Four Family Mortgages

Under the existing risk-based capital rules, most first-lien, one-to-four family mortgages are generally eligible for a 50 percent risk weight. ICBA believes that this "one size fits all" approach to risk-based capital does not accurately assess suitable levels of capital for either low- or high-risk mortgage loans. **Therefore, ICBA endorses the agencies proposal in the ANPR to add additional risk weights (e.g., a 20 percent and 35 percent category) for assessing a bank's one-to-four family mortgage portfolio and to base those risk weights on loan-to-value ratios.**

We also agree that Table 3 of the ANPR is an appropriate way to categorize residential mortgages based on LTV ratios except for one category; we would substitute 75 percent for 100 percent for the top risk weight category (e.g., those loans with LTV ratios of between 91-100 percent). We believe that fully (100 percent) risk-weighting a residential loan which has an LTV of between 91-100 percent is too high a risk assessment. Furthermore, the Basel II banks will most likely be risk rating these loans at much less than 100 percent, resulting in a competitive advantage for those banks. Since these residential mortgage loans seldom result in any measurable loss to the bank, we recommend a 75 percent risk weight for these loans.

If the agencies propose that residential mortgage risk-weights be based on LTV ratios, we recommend that a mortgage loan LTV ratio be determined at the time the mortgage is originated and that banking organizations have the flexibility of updating the risk weights of their mortgage loans as normal principal payments are made and LTV ratios change. We also recommend that a banking organization be permitted to change a mortgage loan to a different risk weight category based on changes to the value of the collateral real estate provided the financial institution has

received a certified appraisal demonstrating that the value of the collateral real estate has changed.

While using credit scores in conjunction with LTV ratios might further enhance the risk sensitivity of the mortgage loan risk weights, it would substantially complicate the process of computing risk-based capital. Besides the fact that some banks do not use external credit scores at all, those that do would have to develop operational methods and software for inputting and tracking the scores and categorizing the loans. Credit scores are also much more volatile than LTV ratios and are frequently inaccurate; therefore, banking organizations would need to periodically update the scores, check their accuracy and possibly change the risk weight category of a loan. For many community banks, it may be more a regulatory burden than a benefit to include credit scores with LTV ratios.

ICBA agrees with the agencies that if a banking institution holds both a first and second lien, including a home equity line of credit (HELOC), the two loans should be combined to determine the appropriate LTV ratio and thus risk weight for both loans. However, we disagree that if the banking institution holds a stand-alone second lien mortgage or HELOC but not the first lien, and the LTV ratio at origination for the combined loans is less than 90 percent than the risk weight for the stand-alone second lien should automatically be included in the 100 percent risk weight category. To more accurately reflect the credit risk of these loans, we believe there should be a 75 percent and possibly a 50 percent risk weight category for stand-alone second liens depending on what the combined LTV ratios are at origination. Furthermore, we do not believe that stand-alone second lien mortgages should have a higher than 100 percent risk weight category if their LTV ratios at origination, when combined with the first liens, are between 91-100 percent.

Certain Commercial Real Estate Exposures

The ANPR states that the agencies are interested in revising the capital requirements for certain commercial real estate exposures such as acquisition, development and construction loans (ADC) loans based on "longstanding supervisory concerns." According to the ANPR, the agencies are considering assigning certain ADC loans to a higher than 100 percent risk weight (e.g., those ADC loans that don't meet the Interagency Real Estate Lending Standards and the project is not supported by a substantial amount of borrower equity).

ICBA is concerned that this approach is too broad and will not adequately address the different types of commercial real estate loans and the kinds of risk mitigation techniques used by banking institutions. Furthermore, we are concerned that such a broad approach may have unintended consequences in the marketplace and impact the availability and cost of credit for small business. Since there are significant differences in risks and underwriting for commercial real estate exposures, we would recommend that this area be studied further

before the regulators decide on a one size fits all approach to ADC loans that don't conform to the Interagency Real Estate Lending Regulations. We believe that the agencies should develop a risk weighting framework for CRE exposures that is not burdensome to community banks and that will protect the safety and soundness of the banking system without impacting the availability of small business credit.

Certain Small Business Loans

Under the agencies' risk-based capital rules, a small business loan is generally assigned to the 100 percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. To improve the risk sensitivity of their capital rules, the agencies are considering a lower risk weight for certain business loans under $1 million.

ICBA agrees with the agencies that there should be a lower than 100 percent risk-weight category for certain small business loans. However, to accommodate banks in metropolitan areas that have experienced high real estate appreciation, we think the $1 million threshold should be raised. Many community banks now routinely make small business loans in excess of $1 million. ICBA recommends that the agencies establish a 75 percent risk weight category for those small business loans that are under $2 million and that are (1) fully collateralized (2) amortizable over a period of 10 years or less, and (3) have been originated consistent with the bank's underwriting policies.

Retail Exposures

ICBA is concerned about the regulatory burden that would be imposed on community banks if retail credits were classified and risk weighted based on credit assessments, such as borrower's credit scores or ability to service debt. As noted above in our discussion of using credit scores for mortgages, we believe that using credit scores could significantly complicate the job of computing risk-weight capital and might end up being more of a burden than a benefit. Similarly, basing the retail loan risk-weight categories on the borrower's ability to service debt would also be very difficult requiring a significant amount of operational and systems expense.

Loans 90 Days or More Past Due

As for assigning loans that are 90 days or more past due (or that are in nonaccrual status) to a higher than 100 percent risk weight category, ICBA believes that the more appropriate way to deal with the risk involved in these kinds of loans is by providing adequate reserve amounts for them through the bank's loan loss reserve account. As long as they are

adequately reserved for, loans that are 90 days or more past due should not have a risk weight category separate from the underlying loan. If they are not adequately reserved for, then the banking institution should increase its loan loss reserves (or face the penalty of having inadequate loan loss reserves) and not be concerned about changing its risk based capital.

Expanding Recognized Financial Collateral

The agencies are also considering expanding the list of recognized financial collateral to include short- or long-term debt securities (for example, corporate and asset- and mortgage-backed securities) that are externally rated at least investment grade by an NRSRO, or issued or guaranteed by a sovereign central government that is externally-rated at least investment grade by an NRSRO. The NRSRO-rated debt securities would be assigned to the risk-weight category appropriate to the external credit rating as shown in Tables 1 and 2 of the ANPR.

To use this expanded list of collateral, banking organizations would be required to have collateral management systems that can tract collateral and readily determine the value of the collateral that the bank would be able to realize. For most community banks, this would be more of a regulatory burden than a benefit. Few community banks make loans that have externally rated collateral. Therefore, we recommend that the new Basel I rules not include a long list of recognized financial collateral that might unduly complicate the task of computing risk-based capital for a typical community bank.

Opt-Out Provision for a Basel IA

Many community banks have excess capital and would prefer to remain under the existing risk-based capital framework without revision. This is particular true for smaller banks that are management-owned, otherwise closely held, or not publicly traded, or banks in rural or other smaller markets. These banks generally hold higher amounts of capital than regulatory minimums—many significantly higher—for a variety of reasons including a conservative philosophy or lack of ready access to raise capital in the capital markets. For instance, the average total risk-based capital ratio for banks under $100 million in assets is 27.3 percent and for banks between $100 million and $1 billion it is around 15-16 percent.[3]

For these banks, computing risk-based capital minimums and ratios using the contemplated Basel 1A could present a significant regulatory burden with no corresponding benefit. This is particularly true since the agencies note in the ANPR that changes in reported Call Report data will be necessary in order to

[3] See FDIC News Release and Chart 3 of the Memorandum from Christopher J. Spoth to the FDIC Board dated October 6, 2005.

capture the additional information for LTV ratios and other risk driver data points such as collateral, loan size, term to maturity, etc.

ICBA strongly recommends that the agencies adopt an "opt-out provision" as part of a revised Basel I that would give highly capitalized community banks the option to continue using the existing risk-based capital rules and avoid the regulatory burden more complex risk-based capital rules. This opt-out provision could be limited to banks with less than $5 billion in assets that have a capital to asset leverage ratio of 7% or higher. Such an opt-out provision would provide significant regulatory relief for community banks that are highly capitalized and have no need to use a more complicated and risk sensitive capital framework.

Quantitative Impact Study Needed for Basel IA; Basel II Capital Floors

Basel II has been subject to four different quantitative impact studies to determine the impact of the new accord on the banking industry and a fifth study is now in process. **ICBA recommends that once the agencies finish their analysis of the comments from the ANPR, they immediately begin a quantitative impact study to determine the impact that a revised Basel I would have on the banking industry and whether the competitive disparities between the two accords would be mitigated by a revised Basel I. A Basel IA QIS also could examine whether community banks, particularly those with excess capital, would benefit from a revised Basel I.** Hopefully, this study could be completed and released in sufficient time prior to the end of the comment period for any Notice of Proposed Rulemaking on Basel I so that the industry can evaluate the results of the study and incorporate them into their comments. Presently, community banks have no statistical information on how a revised Basel I would affect minimum capital requirements and capital ratios throughout the industry.

The agencies note in the ANPR that under the revised Basel II timetable, Basel II banks will be subject to a transitional capital floor (that is, a limit on the amount by which risk-based capital could decline). In the pending Basel II NPR, the agencies expect to seek comment on how the capital floor should be defined and implemented. To the extent that revisions result from the Basel I ANPR process, the agencies seek comment on whether the revisions should be incorporated into the definition of the Basel II capital floor.

As noted in our prior statements to the House and Senate Banking Committees, ICBA strongly supports the decision by the agencies to maintain the capital-to-assets leverage ratio requirement for all banks, including Basel II banks. The Basel II QIS4 results illustrate that under the advanced approach of Basel II, there is potential for substantial deviations in the way banks compute their capital adequacy that is not always explainable by differences in risk. Capital requirements under Basel II depend heavily on the

answers to questions that vary from bank to bank and have no objectively best answer. No matter how refined a risk-based capital framework the regulators come up with, there will always be a need for straightforward capital minimums.

ICBA believes that eliminating or reducing the leverage ratio could jeopardize the safety and soundness of our financial system and pose substantial risks to the FDIC insurance funds. In recent years, U.S. banks have been very sound and profitable. ICBA believes that the current economic health of our economy and financial system is partly due to the strong capital position of banks and the capital requirements, including the leverage ratio and prompt correction action requirements implemented by regulators as a result of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA).

In addition to retaining the leverage ratio, ICBA also agrees with the agencies that Basel II banks should be subject to floors during their three-year transitional period. The agencies are proposing that in 2009, Basel II banks be subject to a 95% floor, in 2010 a 90% floor and in 2011 a 85% floor. **We would suggest that the floors be a percentage of the risk-based capital for those banks calculated in accordance with the original Basel I rules, not the proposed Basel 1A rules.** We would assume that during this time, Basel I banks may be transitioning to Basel 1A risk-based rules and may be subject to floors similar to the Basel II banks. In that case, those floors should also be a percentage of the risk-based capital calculated in accordance with the original Basel I rules. This way, the Basel IA and II transitions can proceed similarly and will permit regulators and the industry to better compare the impact of each accord.

Conclusion

As noted in our comments above, ICBA generally supports the proposed revisions to the Basel I capital rules as described in the ANPR **provided that the new rules have an opt-out provision that would give highly capitalized community banks the option to continue using the existing risk-based capital rules.** We support the use of additional risk-weight categories particularly for mortgage loans and endorse the idea of basing risk weights on LTV ratios. If risk weights are based on LTV ratios, we would recommend that a mortgage loan LTV ratio be determined at the time the mortgage is originated and that banks have the flexibility of updating the risk weights of their mortgage loans as normal principal payments are made and/or as the LTV ratios change. While we acknowledge that pairing credit scores with LTV ratios might enhance the risk sensitivity of the mortgage loan risk weight categories, we feel it may be more a regulatory burden than a benefit to include credit scores with LTV ratios.

With respect to certain acquisition, development and construction loans that do not conform with Interagency Real Estate Lending Regulations, we are

concerned about lumping them all into one risk-weight category and support further study to determine the appropriate risk weight categories. As for small business loans, we recommend that the agencies establish a 75 percent risk weight category for those small business loans that are under $2 million and that are (1) fully collateralized (2) amortizable over a period of 10 years or less, and (3) have been originated consistent with the banking organization's underwriting policies.

ICBA strongly recommends that the agencies adopt an "opt-out provision" as part of a revised Basel I that would give highly capitalized community banks the option to continue using the existing risk-based capital rules and avoid the regulatory burden of more complex risk-based capital rules. This opt-out provision could be limited to community banks with less than $5 billion in assets that have capital-to-asset leverage ratios of 7 percent or higher.

ICBA also strongly recommends that the agencies conduct a quantitative impact study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a revised Basel I. ICBA strongly supports the decision by the agencies to maintain the capital-to-assets leverage ratio requirement for all banks, including Basel II banks and also agrees that Basel II banks should be subject to capital floors during their three-year transitional period. We would suggest that the floors be a percentage of the risk-based capital for those banks calculated in accordance with the original Basel I rules, not the proposed Basel 1A rules.

ICBA appreciates the opportunity to comment on this ANPR and to recommend improvements to the existing risk-based capital rules. If you have any questions about our letter, please do not hesitate to contact me at 202-659-8111 or Chris.Cole@icba.org.

Sincerely,

Christopher Cole

Christopher Cole
Regulatory Counsel