STATE OF NEW YORK
BANKING DEPARTMENT
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DIANA L. TAYLOR
Superintendent of Banks

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
Mail Stop 1-5
Washington, DC 20219
Docket Number 05-16

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

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

Dear Sir or Madam:

The New York State Banking Department welcomes the opportunity to comment on the federal Agencies Advance Notice of Proposed Rulemaking, "Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications," and its focus on risk-based capital calculations for the vast majority of U.S. banking institutions. The Department feels that with further study, additional detail, and some modifications, Basel IA could provide a workable blueprint for risk-based capital calculations at U.S. banks.

The Department's preliminary analysis indicates, however, that minimum risk-based capital levels could drop significantly with adoption of Basel IA, thus it is essential to maintain the PCA leverage requirements for U.S. banking institutions. It is important that supervisors study the possible effects of Basel IA and attempt to project the changes in minimum capital Basel IA might produce, and that sufficient detail be available to carry this out. Supervisors should also be wary of studying Basel IA in isolation, as it is closely tied to the Basel II proposal. Competitive inequities between Basel IA and Basel II banks, in particular, must be kept in mind. The Banking Department presents its recommendations below, followed by a discussion of the overall impact of Basel IA.

Recommendations:

1. Ensure enough time for review of the Basel IA NPR with the Basel II NPR.
Basel IA is closely tied to the Basel II program, as one of its aims is to redress competitive inequities created by Basel II implementation at the largest U.S. banks. Large, medium, and small banks operate in the same markets, and it is essential that supervisors understand the impact of these changes across the U.S. banking system. We ask that the federal Agencies ensure enough time for review and study of Basel IA alongside Basel II, and that these proposals not be pursued as separate programs.

2. Provide sufficient detail in Basel IA NPR to allow rigorous study of its impact.
The ANPR contains many questions and not enough details about how the revisions to capital calculations would be accomplished. Industry response to the ANPR will be useful in filling in these details, but these domestic capital modifications cannot be adequately reviewed until the Agencies release a more specific proposal. At that time, it will be necessary to carry out an impact study of the possible effects of these modifications on the level of minimum required capital and on the market for banking products.

3. Retain the PCA requirements and leverage ratio.
The Department is concerned by the reduction in minimum risk-based capital reported for the QIS 4 participating banks, and is strongly of the opinion that the leverage ratio requirement should be maintained for the forseeable future. While there is undeniable value in banks' improving their risk assessment techniques, minimum capital as determined by the PCA requirements provides an important safeguard for the banking system.

4. Use the Basel IA risk measures to verify Basel II banks' parameter estimates.
Preliminary results of the QIS 4 study showed a wide dispersion in the parameter estimates supporting banks' Basel II capital calculations. This dispersion was evident even for identical credits, and there has been much discussion of the difficulties facing supervisors in verifying the banks' parameter estimates. The Department suggests that supervisors request banks -- particularly Basel II banks -- to systematically provide Basel IA risk measures (loan to value (LTV), credit scores, debt service coverage, external ratings, equity support, etc.) for their portfolios, prior to the beginning of the parallel run of Basel II. The Basel IA risk measures are standard, uniformly available, the basis of credit decisions at all banks, and can reasonably be verified by supervisors. Review of these uniform risk measures -- at both Basel II and Basel IA banks -- will

allow supervisors to better understand the impact across the banking industry of these changes as well as insight into a particular bank's credit risk culture.

5. Address improvements in risk management processes at Basel IA banks. Basel II banks will be allowed to use their own parameter estimates in calculations of regulatory capital once supervisors are satisfied that the banks have established rigorous risk management systems and processes. In contrast, the Basel IA ANPR offers fairly mechanistic changes in capital requirements with few guidelines to improving risk management, data collection, or control processes. The Department recommends that the agencies develop guidelines for the use of loan to value ratios, credit scores, and external ratings; provide expanded and specific guidance on risk measures for small business loans and commercial real estate loans, particularly acquisition, development, and construction (ADC) loans; and address the need for improved controls processes at banks of all sizes. We feel that it is important to recognize improvements banks achieve in their control processes, and are aware that in an interconnected financial system, control processes are not the concern of institutions in isolation.

Impact on Banks with Main Offices in New York State

One of the standards the Agencies note for revisions to risk-based capital regulations is that they should "promote safe and sound banking practices and a prudent level of regulatory capital." Information necessary to conduct a rigorous impact study of Basel IA is not available -- the ANPR is not specific about certain provisions, and banks do not currently report risk parameters such as LTV or external ratings for their exposures. However, as an initial attempt to understand the impact of Basel IA, the Banking Department reviewed assets at New York headquartered banks, consulted with a group of bankers on the provisions of Basel IA, and estimated the rough impact of Basel IA on minimum capital requirements under certain simple assumptions about banks' risk profiles.

The Department reviewed Call Reports as of June 30, 2005, for 156 banks with headquarters in New York State. In addition, the Department asked a group of bankers from state-chartered banks of different sizes to estimate the risk parameters asked for in Basel IA. The Department used the responses from the New York state-chartered banks, as well as a Basel IA calculation template developed with the Conference of State Bank Supervisors, to estimate the risk allocation of banks' portfolios, for example, into loan to value (LTV) or external rating buckets.[1]

We found significant changes in minimum capital requirements both on average and in aggregate when New York bank portfolios were analyzed using the proxy profiles -- "conservative" (allocation into mostly low-risk categories), "NY," "custom" (allocation

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1 See Appendix.

into typical or medium risk categories), and "aggressive" (allocation into higher risk categories). These profiles were applied to the following sub-portfolios2:

- 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 the profile based on risk parameters reported by the group of New York banks was applied to all the New York headquartered banks, minimum capital requirements would decrease on average by about 11%; minimum requirements would drop by about 17% if all banks were under the "conservative" profile; and minimum requirements would increase by about 9% if the "aggressive" profile were in effect at all banks. These results show slightly greater reductions than those reported by the Conference of State Bank Supervisors when the impact at state-chartered banks across the country was studied. New York banks have adopted a variety of risk allocations, so these estimates only suggest the range of possible changes in minimum requirements. However, the changes we found would be significant, and make clear the need for better understanding of banks' actual risk allocations before Basel IA is implemented.

Percent Change in Minimum Required Capital under Different Profiles

	NY	Custom	Conservative	Aggressive
Average	-10.7%	-7.2%	-16.9%	9.4%
Median	-10.5%	-8.1%	-17.5%	9.4%
Std.Dev.	6.1%	4.4%	7.6%	7.4%
Max	0.5%	5.3%	0.0%	36.9%
Min	-27.4%	-19.8%	-44.4%	-15.5%
Aggregate	-6.0%	-4.9%	-12.5%	11.5%

Under the assumptions of the "NY," "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

2 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.

commitments with maturity under one year, and loans on non-accrual. In particular, our banks reported lower LTVs for their mortgage portfolios than in the "custom or typical" CSBS proxy profile. 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 does not constitute an in-depth impact study, but it can give us an indication of the magnitude of possible changes. We urge banking supervisors to conduct a more rigorous study once the detailed Basel IA proposal is available.

Increased Risk Sensitivity under Basel IA

The Basel IA ANPR adds four risk buckets (35%, 75%, 150%, and 350%) to the risk-based capital calculation. Under the new approach, exposures to externally rated counterparties are risk-weighted according to their rating; for example, a loan to a BBB+ rated borrower is risk-weighted at 50%, while a loan to a BB+ borrower is risk-weighted at 200%. This approach to risk-weighting is also available for financial collateral and guarantees when they are supported by external ratings. While these additional buckets increase a bank's ability to recognize different levels of risk, their addition may not significantly increase the risk sensitivity of capital calculations for non-Basel II banks, as very few report exposure to rated borrowers or rated collateral.

Representatives from a group of New York state-chartered banks, when recently asked about the impact of this provision, responded that either none or less than 5% of their loans by dollar amount was to borrowers with external ratings. They also reported that collateral and guarantees for their loan portfolio did not involve entities with public ratings. Risk weighting according to external rating can also be applied to the bank's investment portfolio; however, the portion of New York banks' securities portfolio reported currently at 100% risk is quite small on average, around 2% of total assets.

The increase in risk sensitivity contributed by the ANPR is limited, also, by the absence of specific risk buckets for commercial real estate, acquisition, development, and construction loans, consumer loans, and loans on non-accrual. Analysis of the actual portfolio shares of these asset categories at New York banks shows that they constitute a significant part of banks' portfolios. The share of total assets represented by different asset categories varies by size of bank, with the largest bank portfolios showing a much greater share of consumer loans than the mid-size and smaller banks. The largest banks also show a much smaller share of their portfolio devoted to residential real estate, small business loans, and commercial real estate loans. The ability of the largest banks to readily securitize their loans is undoubtedly a factor here.

For the ANPR to effectively enhance risk sensitivity, the federal Agencies must provide specific detail on risk weighting for commercial real estate loans, consumer loans, and loans on non-accrual and past due 90 days or more. We will also need to understand the composition of portfolios at Basel IA banks before we will know whether the federal

Agencies' proposal will increase the risk sensitivity of banks' capital calculations. Understanding the choices different size banks make concerning asset allocation is also crucial to determining the competitive impact of the proposed regulations.

The greatest impact on capital levels will probably come from the introduction of loan-to- value buckets for risk-weighting residential real estate. Four buckets -- ranging from a risk weight of 20% for loans with a maximum LTV of 60% to a risk weight of 100% for loans with a minimum LTV of 90% -- are suggested in the ANPR. Banks would be able to use these risk buckets for junior liens and HELOCs combined with first liens if the bank also holds the first mortgage to the HELOC or junior mortgage borrower. [This differs from the Basel II Framework, where first liens, junior liens, and HELOCs all receive the same treatment.]

The Banking Department is in favor of recognizing LTV in risk-weighting residential real estate loans, and recommends that LTVs be reviewed periodically or when there are significant shifts in market values of housing. However, the Department is concerned about the risk of holding nontraditional mortgage products, such as interest-only or negative amortization loans, and urges the federal agencies to consider an appropriate additional capital charge for these products.

Average Share of Total Assets at New York Headquartered Banks

Sub-portfolios affected by Basel IA	Banks with assets > $75 Billion (2)	Banks with assets between $1 Billion and $75 Billion (33)	Banks with assets < $1 Billion (121)
Residential real estate (first & junior liens, HELOCs, multifamily)	4.0%	19.8%	20.6%
Wholesale loans & leases (excluding small business)	18.3%	16.5%	7.6%
Small business loans3	0.9%	6.1%	16.0%
Nonfarm nonresidential real estate loans	1.1%	9.7%	16.1%
Acquisition, development, and construction loans	0.1%	2.1%	2.0%
Consumer loans	9.5%	4.0%	4.0%
Securities with Basel I risk-weight of 100%	2.0%	2.4%	2.2%
Unused commitments with original maturity < 1 year	1.4%	0.4%	0.5%
Loans on non-accrual	0.3%	0.2%	0.5%
Loans past due 90 days or more	0.2%	.025%	.094%

3 Includes nonfarm nonresidential real estate loans under $1 million.

Competitive Inequities with Basel II Banks

Changes to risk-based capital regulations for non-Basel II banks must take into account the markets these institutions are active in and their role in their communities. As noted in our earlier discussion of portfolio composition, large regional banks and community banks tend to be very active in commercial real estate lending and in lending to small businesses. This lending activity, of course, is very important, as small businesses are major contributors to private sector output and new job creation.

However, New York banks share the small business market with many other institutions: analysis of the small business lending data for 2004 released by the FFIEC under the CRA program shows that 318 banks reported loans to businesses in New York State with gross annual revenues of $1 million and less. About a quarter of these banks were New York headquartered institutions, and more than half had assets greater than $1 billion. All but one of the 14 largest U.S. banks (those with assets over $75 billion) are represented among these small business lenders. These data make clear that Basel II banks compete with non-Basel II banks in the market for small business lending in New York.

Recent research[4,5] indicates that the largest banks have increased their "small loan" lending (e.g., business credit cards), while smaller banks have increased their share of larger loans to small businesses. The CRA data for New York state lending to businesses with gross annual revenues of $1 million or less show average loan sizes of $94,000 for the 13 banks with assets over $75 billion, $173,000 for banks with assets between $1 billion and $75 billion, and $188,000 for banks with assets under $1 billion.

Under the Basel II Framework, banks are allowed to treat pools of small business loans as retail exposures, which are generally subject to lower risk weights than wholesale loans. This treatment will most likely result in small business loan risk weights much lower than the 75% suggested in the Basel IA ANPR.

Treatment for Commercial Real Estate Exposures

The ANPR seeks comments on alternative ways to make risk weights for commercial real estate (CRE) loans more risk sensitive. Specifically, the ANPR asks for comments on the types of risk drivers, such as LTV ratios or credit assessments, that could be used to differentiate credit quality of CRE loans and how these risk drivers could be used to determine risk weights.

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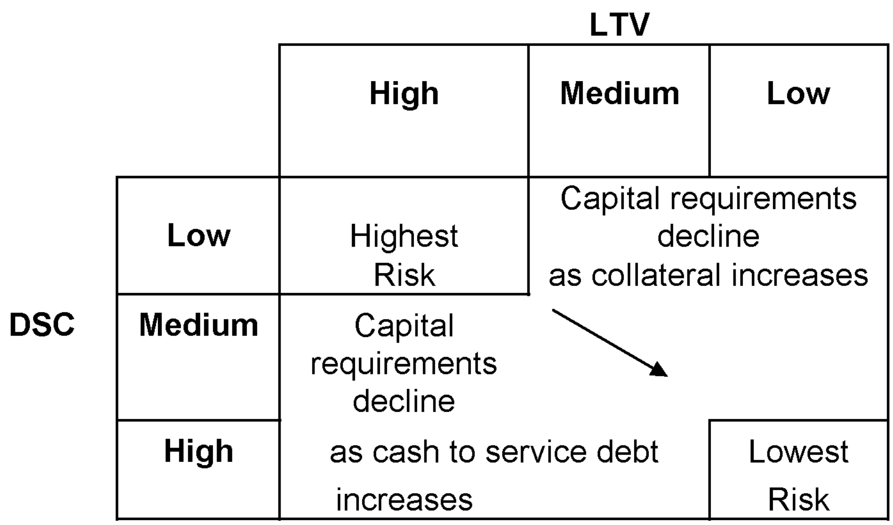
4 Berger, Allen, "Potential Competitive Effects of Basel II on Banks in SME Credit Markets in the United States," Board of Governors of the Federal Reserve System, February 2004

5 SBA Office of Adequacy, "Small and Micro Business Lending for 2003-2004," November 2005

Risk measures for commercial real estate should identify loans where there is at least adequate borrower equity and where the borrower has sufficient ability to repay the loan. They should also involve an appropriate assessment of the underlying collateral. A capital rule based on such measures must incorporate guidance governing the frequency of property appraisals. The Department feels that, with the development of the necessary guidance, it would be possible to design an assessment protocol for CRE loans that could be used as the basis of capital requirements.

One approach would be to use two risk drivers -- loan to value (LTV) and debt service coverage (DSC) in combination. A lower loan to value ratio and higher debt service coverage ratio would lead to lower required capital; as either LTV increases or DSC decreases, capital requirements would be greater, as shown below.



Focusing on cash flow, first, and, then on collateral as a secondary source of repayment could yield an effective risk measure, and one that reflects supervisory experience and underwriting principles. It may be necessary, however, to include another dimension in the risk measure for commercial real estate: most of the bankers the Department consulted felt that risk weighting for acquisition, development, and construction (ADC) loans, at least, should depend on property type. The bankers commented also, that general economic conditions and the particular loan details were important in assessing the risk. Clearly, the amount of borrower's equity, the borrower's ability to meet obligations in distressed times, and the feasibility of the project remain crucial to both the loan decision and to supervision.

<u>*Conclusion*</u>

The Basel IA ANPR attempts to bring risk-based capital calculations for all the non-Basel II banks in the U.S. closer to the approaches envisioned for the largest internationally active banks, without causing undue burden. The agencies aim, in addition to allowing greater risk sensitivity in the capital calculations, to mitigate competitive effects of Basel II. The Department feels that Basel IA is a workable program; however, greater detail and specificity is needed, guidance for the recognition of banks' improvements in risk management and controls should be incorporated, and an in-depth impact study of possible changes in the levels of minimum required capital should be carried out before implementation. The Department strongly recommends maintaining PCA leverage requirements, and urges the federal agencies to pursue Basel IA and Basel II changes together, to ensure that the impact of these wide-ranging revisions to capital requirements is analyzed across the banking system, before adoption of either.

Thank you for this opportunity to comment and for your consideration of our views. Please contact me at your convenience should you wish to discuss this further.

Sincerely,

Diana L. Taylor
Superintendent of Banks

Appendix.

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 (Schedule RC-N), and unused commitments (Schedule 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. In addition, the Banking Department consulted bankers in the state to determine a typical "NY" allocation of credit quality. 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. (However, including past due loans would not have a material effect.)
- 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.