March 21, 2007

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Attention: Docket Number 06-15
regs.comments@occ.treas.gov

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Docket Number R-1238
regs.comments@federalreserve.gov

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
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Attention: Comments/Legal ESS
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Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
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Washington, DC 20552
Attention: No. 2006-49
regs.comments@ots.treas.gov

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications
71 FR 77446-518 (December 26, 2006)

Dear Mesdames and Sirs:

America's Community Bankers (ACB)[1] is pleased to comment on the banking Agencies' joint notice of proposed rulemaking (NPR) issued to solicit comments on proposed changes to the risk-based capital framework for depository institutions in the United States.[2] The revised framework would be available to those banks and savings associations that are not required to comply with, nor are able to opt-in to, the Basel II capital framework for the largest, most complex U.S. banking organizations. The proposal would change the number of risk-weight categories, capital requirements for residential mortgages, and the credit conversion factor for short-term commitments. It would also expand the use of external credit ratings, recognize collateral and eligible guarantors, impose a new capital charge for early amortizations in securitizations involving revolving exposures, and remove the 50 percent limit on the risk-weight for certain derivative transactions. Finally, although not specifically proposed, the NPR

[1] America's Community Bankers is the national trade association committed to shaping the future of banking by being the innovative industry leader strengthening the competitive position of community banks. To learn more about ACB, visit *www.AmericasCommunityBankers.com*.
[2] 71 FR 77446-518 (December 26, 2006)

seeks comments on the use of financial strength ratios in determining the risk-weight for Government Sponsored Enterprise (GSE) exposures, incorporating borrower creditworthiness into risk-weights, and permitting certain small business loans to be risk-weighted at 75 percent.

ACB Position

ACB strongly supports the Agencies' efforts to develop a more risk-sensitive capital framework for non-Basel II banking organizations. We believe that this is a timely endeavor and necessary in order to reflect the changes in risk management and operations at banks that have occurred over the last decade. Without an updated framework for non-Basel II banks, we believe that these institutions would be left at a serious competitive disadvantage when the Basel II framework is adopted in the United States. This in turn would encourage acquisitions of non-Basel II banks as a consequence of the new regulatory regime rather than a result of analysis of economic and financial fundamentals by acquiring institutions.

We believe that the proposed Basel IA framework is a positive step towards addressing the lack of risk-sensitivity within the existing risk-based capital framework (i.e., Basel I) and decreasing the potential for competitive inequity once the Basel II framework is adopted in the United States. The specifics in the proposal offer some much needed flexibility for community banks that wish to more closely align their risk profile and capital requirements. In some cases, an additional burden in reporting and data collection will be necessary to achieve these capital benefits; nonetheless, our members seeking greater risk-sensitivity believe that this is an acceptable trade-off.

However, ACB is disappointed that the proposed changes in this NPR fall far short of what many banking organizations will need to remain competitive in that the proposal fails to provide for a sufficient increase in risk-sensitivity essential for effective risk-based capital requirements. As an example, the Agencies offer a workable proposal to address the capital charge for residential mortgages, but no approach is proposed for other asset categories that potentially make up a significant portion of a community bank's balance sheet. These include other retail exposures as well as commercial and multi-family residential real estate. We question why the Agencies did not propose a more extensive framework that would more closely align the capital requirements with risk for a wider range of asset categories. We strongly urge the Agencies to expand their proposed changes to address more of these issues prior to issuing the final rule. We believe that this expansion is critical to both the successful implementation of the Basel IA framework and the capability of our members to serve their communities in the future.

ACB understands that the time allowance for developing this NPR was limited as a result of industry and legislative pressure related to not only the planned adoption date for the Basel II framework but also the Agencies' assurance of overlapping comment periods for both the Basel IA and Basel II NPRs. Also, we can appreciate the struggles involved in the interagency process for developing a mutually agreeable proposal. However, the Basel IA framework as proposed does not succeed in ensuring the competitive equity of non-Basel II banking organizations.

The following is a summary of our position on the specific portions of this proposal, with more detail on each of these topics provided in the remainder of this comment letter.

- ACB strongly supports granting U.S. Basel II banking organizations the flexibility to choose among the various approaches available in the International Accord[3], as is afforded to their foreign competitors. If the Agencies grant this level of flexibility to Basel II banking organizations, the proposed Basel IA framework must be modified to mitigate competitive inequities resulting from differences between the proposed Basel IA framework and Basel II.

- ACB supports granting banking organizations the ability to remain under current capital requirements if they so choose and is strongly opposed to certain limitations imposed on this choice, as the appropriate capital regime should primarily be a business decision made by the banking organization on an individual basis.

- ACB continues to support a flexible approach to the adoption of available capital regimes and therefore recommends that non-Basel II banking organizations be given the option to either fully adopt the Basel IA proposal or adopt only the proposed changes to the residential mortgage capital requirements, since for many banking organizations, this would alleviate most concerns regarding competitive disadvantages.

- ACB supports the additional risk-weight categories of 35, 75 and 150 percent. We would also recommend including a 10 percent risk-weight category to the final rule for certain asset types.

- ACB supports the determination of risk-weights using LTVs for residential mortgage loans; however, we believe that the risk-weights outlined in the NPR could be improved by including additional risk differentiation for loans with an LTV of 60 percent or less.

- ACB supports the Agencies' proposal to allow institutions the option of updating the LTV to reflect principal balance decline; however, we would like to see this option extended to also allow banking organizations to obtain updated appraisals to even more closely align capital requirements with changing risk.

- ACB believes that the denominator of the LTV ratio should be based on the appraisal of the property obtained at the time of the loan closing, as this is the best indicator of the value of the property and the amount that could be obtained if the property were sold at that time to another buyer in the market.

- ACB disagrees with the Agencies' conclusion concerning pool-level PMI. In recognition of the risk mitigating features to a banking organization's overall risk profile, ACB supports allowing a banking organization that has pool-level PMI to apply it proportionately by loan amount across all loans within the portfolio to which the pool-level PMI applies.

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[3] http://www.bis.org/publ/bcbs107.htm

- ACB supports the Agencies' decision to risk-weight loans with non-traditional features in the same manner as all one-to-four family residential mortgages and agrees with the proposed risk-based capital treatment for the unfunded portion of a loan with a negative amortization feature.

- ACB believes that capital treatment of first and second liens, regardless of whether the same institution holds both, should be consistent to avoid gaming of the system or unnecessary burdens on borrowers who might have to spend more time and money securing second mortgages. In addition, we suggest risk-weighting both first and junior liens under the same revised framework, using the full LTV of the combined exposures to risk-weight the junior lien only.

- ACB disagrees with the Agencies' conclusion that the benefits for any increase in risk-sensitivity for multi-family residential mortgages, commercial real estate or other retail exposures would be outweighed by the additional burden imposed by any potential approaches. For these exposures, ACB believes that stratification into risk buckets similar to the matrix for residential loans as proposed, using LTV and other drivers of credit risk, would provide the needed risk-sensitivity without undue burden for banking organizations willing to adopt Basel IA.

- If the Agencies are unable to offer a more risk-sensitive framework for the assets unaddressed in this NPR, banks should be permitted to use the risk-weights offered in the Standardized Approach for Credit Risk for these particular asset categories. This would provide banks with a more risk sensitive alternative than is currently offered under the existing risk-based capital requirements or Basel IA as proposed.

- ACB strongly opposes any change to the current risk-based capital requirements for GSEs, particularly any revisions that will create a higher risk charge for debt obligations of the Federal Home Loan Banks (FHLBanks).

- ACB supports a revised approach that would provide lower risk-weights for small business loans that meet certain conditions, such as compliance with appropriate underwriting guidelines, no defaults, and full amortization over a seven-year period. However, certain aspects of the suggested approach are too conservative, and we suggest implementing an approach similar to that for residential mortgages utilizing LTV and credit scores.

- ACB believes that a substantial cliff effect occurs with short-term commitments that could be removed by applying more granularity to the credit conversion factor (CCF) for all commitments regardless of term. We would suggest a scalable matrix for slotting commitments based on term to the appropriate CCF.

- ACB does not support the use of external credit ratings in determining the risk of commercial loans without some method for differentiating the risk of unrated companies.

This could include recognition of factors fundamental to the underwriting process, such as quality of collateral and strength of cash flow.

- ACB believes that the proposed risk-based capital treatment for early amortization loans is entirely too complicated. Should the Agencies include a charge for such provisions in the final rule, we would suggest a common treatment for all such securitizations, such as a single CCF.

Basel II and the Relationship to Basel IA

The Agencies are seeking comment on allowing Basel II banking organizations the option to calculate their risk-based capital requirements using approaches other than the Advanced Approaches described in the International Accord. ACB strongly supports granting U.S. Basel II banking organizations the flexibility to choose among the various approaches available in the International Accord, as is afforded to their foreign competitors. This flexibility would include allowing Basel II banking organizations to adopt the Standardized Approach as described in the International Accord.

The proposed Basel IA framework must be modified to mitigate competitive inequities resulting from differences between the proposed Basel IA framework and the Basel II framework. As is currently outlined in the International Accord, Basel II would not only offer a more risk sensitive framework for calculating capital requirements as compared to the current Basel I framework, but it would also grant a competitive advantage to adopting institutions over those banking organizations operating under either Basel I and the new Basel IA framework as proposed. For example, certain exposures, such as most retail loans, will receive a lower capital charge under the Basel II framework than will be permitted under both Basel I and the proposed Basel IA framework. This outcome would be unacceptable for our member community banks.

As stated in our initial position above, the proposed Basel IA framework does not offer adjustments to the required risk-weights for numerous asset categories. We believe that if the Agencies are unable to provide non-Basel II banking organizations with these needed revisions, these banks should be permitted to use the risk-weights offered in the Standardized Approach for Credit Risk for the particular asset categories not addressed in the proposed Basel IA framework that are addressed in the Standardized Approach. This will mitigate the competitive inequity that is certain to occur once Basel II is adopted in the United States, particularly if the Agencies grant Basel II banks the option to adopt the Standardized Approach.

Opt-In Proposal

The Agencies are proposing that a non-Basel II banking organization may choose to either adopt the revisions of this Basel IA proposed framework implemented in their entirety or remain under the existing capital requirements. A banking organization may opt-in to the proposed Basel IA capital requirements by notifying its primary supervisor. It may also request to return to the existing capital requirements by first notifying its primary supervisor, who will then ensure that the existing capital requirements appropriately reflect the organization's risk profile and that the change is not for purposes of capital arbitrage. Finally, the Agencies have proposed to have the

right to require an institution to follow either the proposed Basel IA framework or the existing capital requirements.

ACB supports granting banking organizations the ability to remain under the existing capital requirements if they so choose. There are banking organizations that do not see the need to have more risk-sensitive capital requirements, and the business choice to avoid the additional regulatory burden associated with implementing the proposed Basel IA framework should be respected.

ACB is strongly opposed to certain limitations on this choice proposed in the NPR. The choice to either opt-in to the proposed Basel IA framework or remain under the existing capital requirements primarily should be a business decision made only by the banking organization on an individual basis. Institutions with certain predetermined characteristics such as asset size, complexity, risk profile, or scope of operations should not be required to follow one capital regime or the other. While we respect the Agencies' authority to review and address an institution's capital requirements as a supervisory matter, we would strongly urge the Agencies to include in the final rule an appeals process should an Agency object to an institution's chosen capital regime. The ability to make the best business decision concerning which regime most appropriately suits an institution's profile should be granted to all banking organizations and overridden only with significant justification.

ACB understands and appreciates the Agencies' distaste for allowing banking organizations to "cherry pick" portions of this proposal for their capital requirements. However, we are concerned with requiring the full adoption of the Basel IA framework for all non-Basel II banking organizations wishing to more closely align their capital requirements with their risk as outlined in this proposal. For many of our members, the ability to have more risk-sensitive capital requirements only for residential loans would be sufficient to mitigate any competitive disadvantage they would face with regard to Basel II banks, particularly since it has been long recognized that mortgages are relatively low-risk and the existing capital requirements are too high. However, these organizations may wish to avoid additional burden by opting-out of any additional modifications that are either currently proposed in this NPR or that may be included in the Basel IA final rule. We continue to support a flexible approach to the adoption of available capital regimes and therefore recommend that non-Basel II banking organizations be given the option to adopt only the changes to the residential mortgage capital requirements or the entire Basel IA final framework.

Increased Number of Risk-Weight Categories

The Agencies existing risk-based capital rules contain five risk-weight categories: zero, 20, 50, 100 and 200 percent. Because differentiation of credit quality among individual exposures is generally limited within the existing five categories, the Agencies are proposing the addition of three new risk-weight categories to aid in greater risk differentiation. The new categories would be 35, 75 and 150 percent.
ACB encourages the Agencies to more accurately differentiate risk among all balance sheet assets, not just those mentioned in the NPR. Several asset classes are currently risk-weighted at a level that is disproportionate to their level of risk. For example, certificates of deposit of less

than $100,000 held in insured depository institutions and similar correspondent bank deposits should receive a zero risk-weighting, rather than the current 20 percent.
We strongly encourage the Agencies to continue to look for ways to provide more precise risk differentiation among various assets. For purposes of this proposal, we support the additional risk-weight categories of 35, 75 and 150 percent. We would also recommend including a 10 percent risk-weight category to the final rule for certain asset types, including, but not limited to first lien one-to-four family mortgages with LTVs less than 30 percent.

One-to-Four Family Residential Mortgages

First Lien Risk-Weights

The Agencies' existing risk-based capital rules assign first lien one-to-four family residential mortgages to either the 50 or 100 percent risk-weight category, with the majority meeting the requirements for the 50 percent category. This broad assignment of most first lien mortgages has been criticized for not being sufficiently risk-sensitive. Therefore, the Agencies are proposing to risk-weight first lien mortgages based on LTV as outlined in Table 3 of the NPR. The Agencies also requested comment on approaches that would consider borrower creditworthiness in risk-weighting first lien mortgages. One such approach is outlined in Table 3A of the NPR, which would assign a lower risk-weight to mortgages with a lower LTV that are underwritten to borrowers with a stronger credit history and vice versa.

ACB supports the determination of risk-weights using LTVs for residential mortgage loans, as LTV ratios have historically been a strong indicator of risk. However, we have some concerns regarding the risk-weights outlined in Table 3 of the NPR. We would argue that there needs to be additional risk differentiation for loans with an LTV of 60 percent or less which, in the proposal are grouped together in the 20 percent risk-weight category. For example, a loan with an LTV of 30 percent could most certainly be considered less risky than a loan with an LTV of 60 percent. Therefore, we suggest that Table 3 in the NPR be expanded as indicated below to include one additional risk category that would apply a 10 percent risk-weight to loans with LTVs less than 30 percent.

Loan-to-Value Ratios (in percent)	Currently Proposed	Suggested Alternative
Less than 30	20	10
Greater than 30 and less than or equal to 60	20	20
Greater than 60 and less than or equal to 80	35	35
Greater than 80 and less than or equal to 85	50	50
Greater than 85 and less than or equal to 90	75	75
Greater than 90 and less than or equal to 95	100	100
Greater than 95	150	150

Borrower Creditworthiness

ACB members have various opinions with regard to whether indicators of borrower creditworthiness, such as credit scores, would be more appropriate to put into a matrix with LTV ratios to determine risk. Most of our members believe that the LTV ratio is the best indicator of

the risk of a mortgage loan and that credit scores could be used in combination with LTV ratios, but should not be used in isolation. Credit scores used in this manner provide valuable information and are appropriate indicators of a borrower's ability to repay a loan and, therefore, the risk level of the loan.

There is some concern that any requirement to update the information with regard to credit scores would be too burdensome for many community banks. Therefore, we support an approach that would permit those institutions that wish to include these characteristics in their risk assessment to do so in accordance with parameters established by the Agencies. This gives institutions the greatest flexibility to choose the level of risk-sensitivity that is appropriate to the amount of burden they wish to incur.

Calculation of LTV

The Agencies propose to calculate LTV at origination of the first mortgage as follows. First, the value of the property would be equal to the lower of the purchase price for the property or the appraised value at origination. The appraised value could only be updated when the borrower refinances a mortgage and the banking organization extends additional funds. Second, LTV must be adjusted quarterly for negatively amortizing loans. For loans that are positively amortizing, banking organizations may choose to update LTV quarterly to reflect the decline in principal. Loan-level PMI would be reflected in the calculation of LTV if the insurer is not affiliated with the banking organization and has long-term senior debt (without credit enhancement) externally rated at least at the third highest investment grade by a nationally recognized statistical rating organization (NRSRO).

ACB has several concerns related to the calculation of LTV as outlined in the NPR. First, ACB supports the Agencies' proposal to allow institutions the option of updating the LTV to reflect principal balance decline. However, we would like to see this option extended to also allow banking organizations to obtain updated appraisals if they would like to undertake that burden to better align capital requirements with changing risk. For instance, if a banking organization is lending in a rapidly appreciating housing market, it should have the option to obtain updated appraisals and therefore lower the capital requirements for the associated loans.

ACB believes that the denominator of the LTV ratio should be based on the appraisal of the property obtained at the time of the loan closing, even if such an appraisal is higher than the purchase price. The appraisal is the best indicator or value of the property and the amount that could be obtained if the property were sold at that time to another buyer in the market. A specific purchase price for a single property can be influenced by several factors, including various contingencies the buyer or seller is willing to take on or give up, timing of the sale, the need for the seller to move the property by a particular date or the buyer including closing costs in the purchase price. Such factors can misalign the purchase price from the true value and therefore should not be used in place of an appraisal to determine LTV.

In addition, loan level PMI is not the only form of loan insurance that reduces the risk to banks holding residential mortgage loans. The Agencies believe that pool-level PMI should not reduce the LTV because it absorbs losses on a portfolio basis. However, ACB believes that this is

shortsighted and does not recognize the risk mitigating features of pool level PMI to a banking organization's overall risk profile. In addition to allowing loan-level PMI to reduce LTV, we would also support allowing a banking organization that has pool-level PMI to apply it proportionately by loan amount across all loans within the portfolio to which the pool-level PMI applies. This would recognize the risk mitigation provided by this type of loan insurance.

Non-Traditional Mortgage Products

Due to the difficultly in providing a clear and consistent definition of higher-risk mortgage loans with non-traditional features, the Agencies generally propose to risk-weight such first lien mortgages in the manner described above for all first liens. However, the Agencies believe that loans with a negative amortization feature pose additional risk to a banking organization in the form of an unfunded commitment. The Agencies propose to risk-weight mortgage loans with negative amortization features consistent with the risk-based capital treatment for other unfunded commitments.

ACB supports the Agencies' decision to risk-weight loans with non-traditional features in the same manner as all one-to-four family residential mortgages. We also agree with the proposed risk-based capital treatment for the unfunded portion of a loan with a negative amortization feature as such a provision is similar to a line of credit and creates additional exposure as the loan amount increases.

Junior Lien One-to-Four Family Residential Mortgages and HELOCs

As in the existing risk-based capital rules, the Agencies propose to continue requiring a banking organization that holds both the first and junior lien mortgages on a one-to-four family residential property, where there is no intervening lien, to assign the combined loans to the appropriate risk-weight category outlined in Table 3 in the NPR as shown below. For a stand-alone junior lien mortgage, the Agencies propose that a banking organization use the combined LTV of that loan and all senior loans to determine the appropriate risk-weight for the junior lien. Using the combined LTV, a banking organization would risk-weight the stand-alone junior lien based on Table 5 in the NPR as shown below. The Agencies also propose that banking organizations be required to hold capital for both the funded and unfunded portion of a HELOC.

Loan-to-Value Ratios (in percent)	Table 3: Risk Weights for First Liens	Table 5: Risk Weights for Junior Liens
60 or less	20	75
Greater than 60 and less than or equal to 80	35	100
Greater than 80 and less than or equal to 85	50	100
Greater than 85 and less than or equal to 90	75	100
Greater than 90 and less than or equal to 95	100	150
Greater than 95	150	150

We believe that institutions should be able to treat first and second liens as separate risks if they are carried by the same institution. The first lien carries less risk and is more likely to be repaid in full, so it should carry a lower risk-weighting than the second lien. For example, a first

mortgage with an 80 percent LTV should not have its risk-weight adjusted from 35 percent to 100 percent if the borrower also carries a second lien, bringing the combined LTV to 95 percent. Such an effect will likely cause the lender to be less willing to extend the second lien, forcing the borrower to utilize alternative lending sources and incurring much higher borrowing costs/fees in obtaining the second mortgage.

For stand-alone second liens or HELOCs, if the LTV at origination for the combined loans does not exceed 90 percent, the Agencies propose a 100 percent risk-weighting. If the LTV is over 90 percent, the Agencies believe a risk-weight higher than 100 percent would be appropriate. We do not support this approach. Again, the weighting should be more closely aligned with the actual risk. It should not be set in a way that force lenders to forego second liens because the capital requirements are not proportional to the risk.

The result of the proposal is that if the lender holds a first mortgage with an 85 percent LTV, that loan would have a risk-weight of 50 percent. If the lender holds only a second mortgage where the combined LTV is 85 percent, the risk-weight for the second mortgage is doubled to 100 percent even though the risk is the same based on an LTV ratio. We do not believe this is the proper result. Capital treatment of first and second liens, regardless of whether the same institution holds both, should be consistent to avoid gaming of the system or unnecessary burdens on borrowers who might have to spend more time and money securing second mortgages.

Therefore, ACB suggests that first liens be risk-weighted separately, regardless of whether or not the same banking organization holds the junior liens. Risk-weighting should be in accordance with Table 3 in the NPR incorporating the recommended revisions noted above in the first lien risk-weights discussion and included again below for reference. In addition, we suggest risk-weighting junior liens under the same revised Table 3 framework shown below, considering the full LTV of the combined exposures for the junior lien only. We do not agree with the suggested risk-weights outlined in Table 5 for junior liens, but rather support risk-weighting these exposures according to the revised Table 3 shown below.

Loan-to-Value Ratios (in percent)	Currently Proposed	Suggested Alternative
Less than 30	20	10
Greater than 30 and less than or equal to 60	20	20
Greater than 60 and less than or equal to 80	35	35
Greater than 80 and less than or equal to 85	50	50
Greater than 85 and less than or equal to 90	75	75
Greater than 90 and less than or equal to 95	100	100
Greater than 95	150	150

For example, if a banking organization holds a first lien with an 80 percent LTV and a junior lien with a 10 percent LTV, we suggest that the first lien carry a risk-weight of 35 percent and the junior lien carry a risk-weight of 75 percent, which is the risk-weight for loans with LTVs of 90 percent, or the combined LTV of the entire exposure.

Multi-Family Residential, Other Retail Exposures, Commercial Real Estate

ACB is very disappointed that the Agencies decided not to include a proposal for revisions to the risk-based capital rules for numerous other asset categories such as multi-family residential mortgages, other retail exposures, and commercial real estate exposures, which can make up a significant portion of many non-Basel II banking organizations' balance sheets. The Agencies stated that the benefits for any increase in risk-sensitivity for these asset types would be outweighed by the additional burden imposed by any approaches.

ACB strongly disagrees. We therefore urge the Agencies to analyze the makeup of the balance sheets of non-Basel II banking organizations, as it will be clear that a large percentage of assets held on these institutions' balance sheets remain unaddressed by the Agencies in this proposal. Community banks are currently required to hold excess amounts of capital for a significant portion of their balance sheet where the risk does not warrant such a capital charge. We strongly encourage the Agencies to allow the banking organizations to determine themselves if the burden of calculating a more risk sensitive capital charge outweighs the benefit of adopting a new approach.

Multi-Family Residential Mortgages

Multi-family residential mortgages currently receive a risk-weighting of 100 percent, except for certain seasoned loans that may qualify for a 50 percent risk-weighting. ACB believes that a stratification of these loans into risk buckets similar to the matrix for residential loans as proposed would be appropriate. We recognize that the risk-weighting for these loans would have to take into account the higher average risk of this type of lending relative to one-to-four family residential lending, but multi-family loans should be treated as having lower average risk than most other classes of commercial real estate lending.

LTV ratios are the most accurate predictor of a mortgage loan's risk, and we believe that the buckets used to determine the risk-based capital requirements should primarily be based on these ratios. As a suggestion, we have included the following table, which illustrates how multi-family residential mortgages can be stratified according to LTV, taking into consideration the higher risk for these exposures in comparison to a one-to-four family residential loan.

Loan-to-Value Ratios (in percent)	Suggested Risk Weights
Less than 30	20
Greater than 30 and less than or equal to 60	35
Greater than 60 and less than or equal to 80	50
Greater than 80 and less than or equal to 85	75
Greater than 85 and less than or equal to 90	100
Greater than 90	150

Other Retail Exposures

ACB believes that borrower credit scores could be utilized to more accurately align risk with capital requirements for automobile lending and other secured consumer lending in a very simplistic manner. LTV could also be incorporated at the option of the banking organization as there are objective, standard resources for determining the value of an automobile and other types of collateral. Where available, these factors should be considered when risk-weighting these retail exposures. The Agencies have already developed a workable matrix for utilizing such inputs as shown Table 3A of the NPR. With minor adjustments to this framework, it could be used for risk-weighting retail exposures. As a suggestion, we have included the following table to illustrate how the Agencies could apply the template from Table 3A to differentiate risk for these particular exposures.

Loan-to-Value Ratios (in percent)	Credit History Group 1	Credit History Group 2	Credit History Group 3
Less than 30	10	20	35
Greater than 30 and less than or equal to 60	20	35	50
Greater than 60 and less than or equal to 80	35	50	75
Greater than 80 and less than or equal to 90	50	75	100
Greater than 90	75	100	150
No LTV incorporated - Credit History Only	50	75	100

Commercial Real Estate Exposures

Currently, loans made related to commercial property are subject to 100 percent risk-weighting. We understand the concerns that the Agencies have had regarding the risk associated with commercial real estate loans. However, capital requirements should be proportionate to the risk to ensure that prudent commercial real estate lending is not discouraged. This is a primary area of lending where our member community banks compete with the larger banks and they should not be left at a competitive disadvantage. Therefore, we suggest that the Agencies develop a matrix similar to our suggestion for other retail exposures above, incorporating LTV and other relevant credit indicators. We have included the following table to illustrate how the Agencies could apply the template from Table 3A in the NPR to differentiate risk for these particular exposures.

Loan-to-Value Ratios (in percent)	Credit History Group 1	Credit History Group 2	Credit History Group 3
Less than 60	20	35	50
Greater than 60 and less than or equal to 80	35	50	75
Greater than 80 and less than or equal to 90	50	75	100
Greater than 90	75	100	150

Alternative Approach for Unaddressed Assets

We offer suggestions above for addressing the concern with regard to multi-family residential mortgages, other retail exposures, and commercial real estate exposures. However, as stated previously, we understand that the Agencies may struggle coming to a consensus for such assets under the limited time frame between now and planned implementation. Therefore, as a less

preferred alternative, we believe that banks could be permitted to use the risk-weights offered in the Standardized Approach for Credit Risk for these particular asset categories as this would provide banks with a more risk-sensitive alternative than is currently offered under the existing risk-based capital requirements or Basel IA as proposed. ACB strongly believes that the assets should be addressed in the final rule and not set aside for future consideration. Banking organizations have been operating under an inadequately risk-sensitive framework long enough and should be given the opportunity to calculate their capital requirements more appropriately.

Government-Sponsored Enterprises

The Agencies' existing risk-based capital regulations assign a 20 percent risk-weight to debt exposures issued or guaranteed by GSEs, and the NPR retains this risk-based capital treatment. However, the Agencies are seeking comment on various types of ratings that might increase the risk-sensitivity of risk-weights assigned to GSEs. Specifically, Fannie Mae and Freddie Mac currently obtain and disclose separate ratings from S&P (risk to the government rating) and Moody's (bank financial strength rating). Collectively, financial strength ratings evaluate the "independent financial strength (IFS)" of each GSE primarily as a measure of risk to the U.S. government. The Agencies are seeking comment on whether to use financial strength ratings to determine risk-weights for debt exposures to GSEs where this type of rating is available and how to treat GSEs that currently do not have ratings.

ACB strongly opposes any change to the current risk-based capital requirements for GSEs. We believe that the current 20 percent risk-weight adequately captures the risk associated with such exposures and any changes to this requirement could have significant, unintended consequences for these stable sources of funding for our member banks.

If the Agencies determine that GSE exposures are in need of revision, ACB would strongly oppose any capital framework that will create a higher risk charge for holding certain exposures to any unrated GSE, particularly the Federal Home Loan Banks (FHLBanks) versus "rated" GSEs such as Fannie Mae and Freddie Mac for several reasons. First, any increase would fail to recognize the extraordinary guarantees supporting FHLBank debt, which do not exist for the debt of any other GSE. In particular, FHLBank debt is the joint and several obligation of each of the 12 independent FHLBanks, and the debt is also protected by statutory capital calls, if needed, on the over 8,000 members of the FHLBank System. As a result, FHLBank debt generally trades at prices equal to or better than that of the secondary market GSEs that have "IFS" ratings. The Basel capital regimes should recognize the quality of FHLBank debt as at least equal to that of other GSEs.

Second, any additional risk-weights in excess of the currently required 20 percent for FHLBank debt will translate into an additional premium demanded by the market and consequently higher funding costs for FHLBanks, translating into higher consumer housing finance costs.

Finally, smaller community banks will be the hardest hit by a higher risk charge for unrated GSE debt as it is these institutions that hold the highest percentage of FHLBank securities. As has been the case throughout its history, the FHLBank System continues to be a critical source of funding for member institutions that are not large enough to obtain funding from other sources at

prices that are affordable. The Agencies have in the past recognized the importance of this source of liquidity for their regulated entities, both big and small.

In conclusion, we would strongly recommend that the Agencies not move forward with any changes to the existing capital requirements for GSE obligations, particularly any revisions that would impose an unjustifiably higher charge on unrated GSE debt. Not only will this serve to discourage investment in the FHLBank System, but it will also damage a stable funding source for community banks.

Small Business Loans

The Agencies' existing risk-based capital rules generally assign business loans to the 100 percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. The Agencies are seeking comment for permitting certain small loans to businesses that meet specific criteria to qualify for a 75 percent risk-weight. The Agencies have suggested that in order to receive the 75 percent risk-weighting, a small business loan should meet the following criteria: 1) consolidated exposure to the individual is $1 million or less; 2) loans are personally guaranteed by the owner and fully collateralized by the assets of the business; 3) loans are fully amortized over a period of no more than seven years with an exception for certain short-term loans that do not amortize; 4) loans are both prudently underwritten and performing; and 5) loans must not have been restructured to prevent a past due occurrence or used to service any other outstanding loan obligation.

ACB supports a revised approach that would provide lower risk-weights for small business loans that meet certain conditions, such as compliance with appropriate underwriting guidelines, no defaults, and full amortization over a seven-year period. We question, however, certain aspects of the suggested approach provided by the Agencies in the NPR and believe the overall suggested approach to be too conservative.

First, full collateral coverage should not be the only way a small business loan qualifies for a lower risk-based capital treatment. This is inconsistent with the expanded collateral proposal in the NPR where portions of an exposure can be collateralized and risk-weighted individually. Any portion of a small business loan that is partially collateralized by a rated instrument should qualify for the lower risk treatment, as outlined in Tables 1 and 2 of the NPR.

Second, we believe that an approach which provides two or three different risk-weights based on various factors similar to the matrix proposed in the residential mortgage portion of the proposal would be appropriate for the remaining portions of the small business loan that are collateralized by all other assets. Because banks take into consideration multiple variables during the underwriting process for small business loans, we believe that an approach that utilizes LTV and the credit score of a principle shareholder that guarantees the loan would provide even more alignment with risk. With such an approach, multiple buckets could be offered based on the results of the LTV and credit assessment. We would suggest that the Agencies use Tables 3A and 5A in the NPR as templates for small business loan risk differentiation.

Third, concerning the suggested approach for short-term commitments, we agree that an exception should be made to the full amortization requirement in order to qualify for the lower risk-based capital requirement. However, we believe that it is too restrictive to require refinancing to already be in place at the loan's inception. This is not indicative of current practice and would continue to force banking organizations to hold more capital than the risk of such exposures would warrant. Therefore, we believe that there should be no amortization requirement for small business revolving lines of credit to qualify for the lower risk-weight.

Finally, we believe that the definition of small business loan should be changed to include those loans under $2 million on a consolidated basis to a single borrower. This would be consistent with the clear definition of "small business loan" provided in the OTS lending and investment regulations.

If the Agencies are unable to provide non-Basel II banking organizations with revised risk-based capital requirements for small business loans as discussed above, ACB suggests that the portion of the Standardized Approach addressing small business loans be an option for institutions to utilize in order to more accurately align risk with capital requirements for these particular exposures. We firmly believe that the current requirement of 100 percent is inappropriate for these asset types and the Standardized Approach provides a framework for allowing a lower capital charge for small business loans meeting certain conditions. This would be a more favorable alternative to the current risk-based capital framework related to small business loans.

Short-Term Commitments

Under the Agencies' existing risk-based capital rules, short-term commitments (original maturity of 1 year or less) and unconditionally cancelable commitments are converted to an on-balance sheet credit equivalent using a zero percent CCF. Effectively, banking organizations extending these types of commitments are not required to maintain risk-based capital against these exposures. Long-term exposures (original maturity of greater than 1 year) are converted to an on-balance sheet credit equivalent using a 50 percent CCF. The Agencies are proposing to maintain a zero percent CCF for commitments that are unconditionally cancelable. However, for short-term commitments, the Agencies propose to raise the CCF to 10 percent.

We believe that the substantial cliff effect that occurs with short-term commitments should be removed by applying more granularity to the CCF for all commitments regardless of term. A commitment that has a remaining maturity of 13 months would currently be converted to an on-balance sheet credit equivalent using a 50 percent CCF while a commitment with 12 months remaining would be converted using a zero percent CCF. While the Agencies' proposal to increase the CCF for short-term commitments is a step in the right direction, we believe this could be improved. We would suggest a scalable matrix, as illustrated in the chart below, for slotting commitments based on term to the appropriate CCF.

Original Loan Term	CCF
Less than or equal to 1 year	0%
Greater than 1 year and less than 3 years	10%
Greater than 3 years and less than 5 years	20%
Greater than 5 years	50%

External Credit Ratings

The existing risk-based capital rules permit the use of external credit ratings issued by an NRSRO to assign risk-weights to certain types of exposures.[4] The Agencies are proposing to use such ratings to determine capital requirements for a broader range of direct exposures. The Agencies recognize that expanding the use of external ratings may have little effect on the risk-based capital requirements for existing loan portfolios at most community banking organizations. The changes proposed would primarily address commercial lending and no changes are proposed for loans to unrated companies.

ACB does not support the use of external credit ratings in determining the risk of commercial loans without some method for differentiating the risk of unrated companies. This could include recognition of factors fundamental to the underwriting process, such as quality of collateral and strength of cash flow. Many community bank commercial loans are made to businesses that are not assigned credit ratings, but are good credit risks with low probability of default. It would be unfortunate if capital requirements discouraged lending to strong companies that help create jobs in the community simply because the company is not rated by a recognized rating agency. We support capital requirements for commercial loans that are simple, encourage approval of loans to creditworthy, unrated businesses, and avoid any competitive disadvantage to the community banks that make most of their commercial loans to unrated companies based on sound underwriting practices.

Recognized Financial Collateral and Eligible Guarantors

The existing risk-based capital rules recognize limited types of collateral, such as cash on deposit and certain government, government agency and government-sponsored enterprise securities for reducing the risk-weight of certain assets. The Agencies are proposing to expand this list of eligible collateral to include externally rated long- and short-term debt securities and securitization exposures. Any portions of an exposure collateralized by these instruments would be assigned to risk-weight categories according to the risk-weight of the instrument.

Under the existing risk-based capital rules, the recognition of third party guarantees is also limited. As a result, the Agencies are proposing to expand the list of eligible guarantors by recognizing entities that have long-term senior debt rated at least investment grade.

The institutions that would benefit from such a change are those that take externally rated collateral or receive guarantees from rated organizations. Many community banks do not take collateral in the form of rated securities, and although many of our members receive personal guarantees for small business loans and commercial loans, these guarantees are from individual shareholders and not guarantors with externally rated long-term senior debt.

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[4] Recourse obligations, direct credit substitutes, residual interests (other than credit enhancing interest only strips), and asset- and mortgage-backed securities are currently assigned risk-weights using external ratings.

Early Amortization

The Agencies' existing risk-based capital rules do not assess a capital charge for risks associated with early amortization of securitizations or revolving credits. In recognition of the risks associated with these early amortization structures, the Agencies are proposing to apply an approach based on excess spread in order to determine risk-based capital requirements for all revolving credits with early amortization features. ACB believes that the proposed risk-based capital treatment for early amortization loans is entirely too complicated. Should the Agencies include a charge for such provisions in the final rule, we would suggest a common treatment for all such securitizations, such as a single CCF.

Conclusion

In summary, ACB strongly supports the Agencies' timely efforts to develop a more risk-sensitive capital framework for non-Basel II banking organizations. We believe that the proposed Basel IA framework is a positive step towards addressing the lack of risk-sensitivity within Basel I and decreasing the potential for competitive inequity once Basel II is in place. However, ACB believes that the proposed changes in the Basel IA NPR fall far short of what many banking organizations will need to remain competitive as it fails to provide for a sufficient increase in risk-sensitivity essential for effective risk-based capital requirements. ACB continues to urge the Agencies not to delay implementation of these necessary revisions and to expand their proposed changes to address more of these issues in the final rule.

ACB appreciates the opportunity to provide this comment letter and intends to remain engaged on this important matter. If you have any questions, please contact the undersigned at (202) 857-5088 or via email at rdavis@acbankers.org or Jodie Goff at (202) 857-3158 or via email at jgoff@acbankers.org.

Sincerely,

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