THE FINANCIAL SERVICES ROUNDTABLE

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Communications Division Public Information Room Mail Stop 1-5 Office of the Comptroller of the Currency 250 E Street, S.W. Washington, DC 20219 Docket No. 06-15	Ms. Jennifer J. Johnson, Secretary Board of Governors of the Federal Reserve System 20th Street and Constitution Ave., N.W. Washington, DC 20551 Docket No. R-1238
Regulation Comments Chief Counsel's Office Office of Thrift Supervision 1700 G Street, N.W. Washington, DC 20552 Re: No. 2006-49	Robert E. Feldman, Executive Secretary Federal Deposit Insurance Corp. ATT: Comments/Legal ESS 550 17th Street, N.W. Washington, DC 20429 Re: RIN 3064-AC96

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

Dear Sir or Madam:

The Financial Services Roundtable[1] appreciates this opportunity to comment on the joint notice of proposed rulemaking ("NPR") to establish an alternative risk-based capital framework for non-Basel II banking organizations ("Basel I-A").

I. Introduction

In the United States, depository institutions and bank holding companies (banking organizations) are required to comply with both a leverage and risk-adjusted capital requirement. The leverage requirement is based on total on-balance-sheet assets without any adjustment for risk. Recognizing the short comings of this system, the banking regulators of the world's leading

[1] The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, investment products and services to the American consumer. Roundtable member companies provide fuel for America's economic engine accounting directly for $18.3 trillion in managed assets, $678 billion in revenue, and 2.1 million jobs.

economic countries developed a rudimentary risk-based capital system that was agreed to in 1988,[2] and implemented in the U.S. beginning in 1989 ("Basel I").[3] The Basel I framework was developed prior to the availability of modern techniques for calibrating risk, and today is viewed as a crude and ineffective tool for aligning capital with economic risk.

In light of the recognized weakness in Basel I, the international bank regulatory community determined to formulate a new risk-based capital standard. This new framework, Basel II Accord, was agreed upon in June 2004, and is currently being implemented both in the U.S. and abroad. Domestically, the regulatory agencies are proposing only the most advanced methodologies in the Basel II Accord, and are proposing to limit the use of these methodologies to the very largest banking organizations.[4]

This NPR is intended to provide an alternative for non-Basel II institutions, along with the option to continue to use the existing Basel I standard. Institutions would not be able to use only parts of the new proposal. It would be an "all or nothing" option. One major goal of this proposal is to provide a more risk-sensitive alternative to Basel I, but without the extensive regulatory burden associated with the Basel II approach. The proposal is also intended to mitigate the competitive concerns created by two capital standards, one for larger banks and the other for the remainder of the industry.

The Roundtable believes that the goals of the NPR are critically important to the financial community and to consumers. However, as will be discussed below, the Roundtable also believes that considerable improvements should be made in the final regulation.

II. Recommendations

A. Flexibility for Basel II Banking Organizations

The NPR specifically asks for comments on whether Basel II banking organizations should have the option to calculate their risk-based capital using methodologies other than the Advanced Approach for credit risk.

Unlike the NPR, the international Basel II Accord provides banking organizations (of any size) with several options for complying with the new capital framework. The least burdensome option, and the easiest to apply, is the so-called "Standardized Approach." In addition, the international Accord offers a more complex "Foundation Approach" and an "Advanced Approach" that is the most complex and costly. In this country, only a U.S. version of the Advanced Approach is currently being proposed

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[2] Basel Committee on Bank Supervision, "International Convergence of Capital Measurement and Capital Standards" (1988).

[3] 12 CFR Part 3, Appendix A (OCC); 12 CFR Parts 208 and 255, Appendix A (Board); 12 CFR Part 325, Appendix A (FDIC) and 12 CFR Part 567 (OTS).

[4] A Basel II NPR was published on September 25, 2006 (71 Fed. Reg. 55830). The Roundtable is submitting a separate comment letter regarding this NPR.

We strongly believe that U.S. depository institutions should be given the same options offered to foreign institutions. In particular, we believe that the internationally agreed to Standardized Approach (which is described in detail in the Basel II Accord) should be made an option for all banking organizations. The Standardized Approach is much less burdensome than the Advanced Approach, and can be implemented by banking organizations of various sizes and complexity. It is a vast improvement over the current Basel I standard, and will much better align capital and risk. For larger institutions it will provide an important option that will enable these companies to be "Basel compliant" without the need to invest enormous sums in systems that are not necessarily the best or most current in terms of risk measurement. For business purposes and as mandated by supervisory guidance, large banking organizations must utilize state of the art risk measurement and risk management systems internally. However, under the U.S. proposed Advanced Approach, alternative risk measurement systems would also have to be developed at great cost that would only be used to comply with the regulation. The use of the Standardized Approach would eliminate the need to develop this costly duplicative system.

The NPR also asks for comments on the measurement of Operational Risk should the Standardized Approach be authorized. The Roundtable believes that Basel II mandatory banking organizations opting for the Standardized Approach should be given the flexibility to use *any* of the Basel II authorized methods for determining an Operational Risk capital charge.

B. Increase the Number of Risk Weight Baskets

The NPR would increase the number of risk-weight baskets from five to eight, by adding new baskets of 35, 75, and 150 percent. We suggest adding a 10 percent risk-weight basket as well, for assets that have little credit risk, such as prime first mortgage loans with a very low loan-to-value ratio.

C. Use of External Credit Ratings

Currently, the Basel I framework considers external credit ratings for only select assets, such as asset-backed securities. The NPR would extend this treatment to a wide variety of rated assets, including corporate debt. Risk-weights would range from 20 percent to 200 percent depending on the external rating.

The Roundtable believes that an external rating of investment grade or better is a good indication that the asset has significantly lower than average credit risk, and that this should be recognized in the capital risk-weights.[5] On the other hand, the proposal imposes a capital penalty for assets that receive a below investment grade rating, despite the fact that such assets may have less credit risk than unrated positions. This creates the perverse effect of encouraging the flow of bank funds to unrated positions at the expense of rated positions that are below investment grade. Further, bank customers would have an incentive to abstain from obtaining

[5] The Roundtable is concerned that this proposal would have only limited benefit for most loan exposures since the counter-parties typically will not have an external rating, and the cost of obtaining such a rating would be prohibitive. The NPR states that the agencies are not proposing to allow a non-Basel II bank to use an internal rating metric for risk weighting purposes. However, another approach is to allow non-Basel II banks to assign risk weights based on objective data that is not internally developed. For example, a non-Basel II bank could be allowed to assign a risk weight based on the industry-wide historic loss experience for each asset class, e.g., loans to automobile dealers, loans to fast food restaurants, etc.

external ratings. We, therefore, recommend that the agencies delete the punitive capital charges for below investment grade positions.

The NPR provides that risk-weight determination is to be based on the NRSRO rating of the exposure, except that in the case of sovereigns, the rating of the issuer may be used if the exposure is not rated. The Roundtable notes that, with respect to corporate loans, the issuer may have long-term debt that has received a rating, but that the bank loan itself will not be rated. The failure to permit the use of such ratings for corporate borrowers significantly diminishes the benefits of the proposal.

The proposal currently does not require more than one external rating, and the Roundtable urges that this requirement not be expanded to require additional ratings. Requiring more than one rating would be costly, would increase regulatory burden, and would significantly limit the benefit of the proposal. On the other hand, the requirement to use the lowest rating for exposures with more than one rating should be reconsidered. Consistent with the Basel II approach, banks should be able to rely on the rating of one of the nationally recognized statistical rating organizations.

D. Financial Collateral and Guarantors

The Basel I framework currently provides beneficial capital treatment if an asset is collateralized or guaranteed by cash, U.S. or OECD government securities, and similar government related instruments, including GSE issued or guaranteed securities. The NPR proposes to *expand* the types of recognized collateral to include other externally rated debt securities. Non-OECD government obligations that have an investment grade rating or that are issued by a sovereign with an investment grade issuer rating would also be recognized. Guarantees will be recognized if the issuer's long-term senior debt has an investment grade rating.

The Roundtable believes that *all* collateral that may be legally perfected and that has an objective method of valuation (or that can be readily market-to-market) provide credit enhancement that should be recognized in a risk sensitive capital framework, regardless of the ratings of the borrower. We urge the agencies to include such collateral in the final regulation.

It is important that the agencies take into account the different techniques that banking organizations employ for tracking and monitoring collateral, and the regulation permit individual institutions to continue to use such techniques, and not mandate new uniform collateral tracking and monitoring procedures.

E. Use of External Ratings for Depository Institutions and Securities Firms

The NPR asks if external ratings should be used to determine risk-weights for all rated exposures, collateral, and guarantees. Currently, certain exposures, such as OECD-chartered depository institutions and OECD-regulated securities firms, are assigned to the 20 percent risk-weight in light of the fact that these institutions operate under stringent governmental supervision. The Roundtable does not believe that a change in the treatment of such exposures is warranted.

F. Government Sponsored Enterprises

Under the existing risk-based capital framework, the risk-weight assigned to exposures issued or guaranteed by a Government Sponsored Enterprise ("GSE") is 20 percent. The preamble notes that the agencies are considering a new approach under which the risk-weight of GSE issued or guaranteed exposures would be based on the risk the GSE presents to the government. This risk would be measured by the use of an "independent financial strength" ("IFS") rating assigned by an NRSRO for each GSE. We believe that the implementation of such a concept would be bad public policy and contrary to the purposes of a risk-based capital system.

The use of IFS ratings for setting risk-weights is inconsistent with one of the fundamental purposes of Basel I-A, to better align capital to the risks in a depository institution's portfolio. The IFS is not a measure of risk to the depository institution holding the asset. Rather, it is an attempt to measure the theoretical risk to the government that is posed by the GSE's activities. The potential risk to the government is not equivalent to the potential risk to holders of GSE securities, which is reflected in the normal credit rating assigned by the NRSRO (the "investor rating"). Put simply, the risk to the government is not an appropriate basis for assigning risk-weights to bank assets.

The proposal would also have an adverse impact on consumers. The GSEs were established to provide for more liquid, more efficient and more economical financing for such things as housing, education, and agriculture. By adding an element of uncertainty with respect to the capital costs of holding GSE issued or guaranteed securities, the proposal will raise the funding costs of the GSEs. These costs will ultimately be passed on to the consumers, whether they are homebuyers, students, farmers, or others. To the extent that the GSEs were established by Congress to reduce financing costs, this proposal would appear to be contrary to public policy, and should not go forward.

G. First Lien Residential Mortgage Loans

The proposal improves upon the current 50 percent risk-weight for prudently underwritten first mortgage loans by assigning a risk-weight based on the loan-to-value ("LTV") ratio of the exposure. However, the proposal could go much further.

Under the Basel II advanced approach, the traditional mortgage loan will likely have an average risk-weight of only 16 percent, and a majority of such loans will have a risk-weight of less than 10 percent.[6] Under the Basel I-A proposal, a traditional mortgage loan with an LTV as low as 61 percent will be assigned a risk-weight of 35 percent, and the lowest possible risk-weight, 20 percent, will only apply to mortgage loans with an LTV of 60 percent or less. The proposed risk-weights for traditional mortgages are not justified by the risk posed by these assets, and unless they are reduced, they will be a significant impediment to achieving the goal of mitigating competitive concerns arising from the Basel II proposal. We suggest that a risk-weight category of 10 percent should be established for the safest mortgage loans, and that the

[6] See, Memorandum of Sandra Thompson, Director, FDIC Division of Supervision and Consumer Protection to the FDIC Board of Directors, Nov. 7, 2006

risk-weight for other traditional first loans with an LTV of 80 percent or less should not be higher than 20 percent.

We also note that the proposal would assign a 150 percent risk-weight for mortgage loans in which the LTV is greater than 95 percent. This would result in a higher risk-weight for secured mortgage loans than for unsecured loans to the same borrower. It makes no sense to penalize a bank or thrift institution for taking collateral. To the extent that the agencies have concerns that these loans are not being underwritten properly, the solution should be in the form of supervisory guidance or other corrective action, not in the form of a capital penalty that affects all institutions.

H. Second Liens and Home Equity Lines of Credit

The NPR proposes a new rule for "stand alone" second mortgage loans and "stand alone" Home Equity Lines of Credit ("HELOC") that are held by institutions that do not hold the first lien on the property. Under the proposal, these loans would be combined with the first loan for purposes of determining LTV ratios. In addition, a percentage of the unfunded portion of the HELOC would also be considered in the LTV computation. The risk-weight of the stand alone second loan or stand alone HELOC would then be assigned to a basket of between 75 percent and 150 percent as follows:

LTV	R/W
60% or less	75%
60% - 90%	100%
Greater than 90%	150%

We note two problems. First, the proposal applies a higher risk-weight to stand alone second exposures with the same LTV ratio as first loans or to first and second exposures held by the same institution. To the extent that these loans are protected by equivalent collateral positions, logic dictates that they should have equivalent risk-weights. The agencies present no explanation for why a second loan with a combined LTV ratio of 60 percent or less should be in the 75 percent basket, when an equivalent exposure held entirely by a single institution is assigned a 20 percent risk-weight.

Second, when the LTV is more than 90 percent, the proposal would impose a higher risk-weight (150 percent) for a secured loan than for an unsecured loan to the same borrower. If the agencies are concerned about the underwriting standards used by some institutions when making higher LTV second loans, such concerns should be addressed through supervisory tools and not capital regulations.

I. Short-Term Commitments

The Roundtable believes that both short-term and long-term commitments should be converted to on-balance sheet assets using a credit conversion factor of 20 percent. The Roundtable agrees that commitments to originate 1-4 family mortgage loans made in the ordinary course of business should not be included, and that capital charges should not apply to commitments that are unilaterally cancellable by the lender.

J. Early Amortization

Credit card receivables and other revolving credits that are sold into a securitization structure are not on the balance sheet of the originating bank. However, as part of the securitization process, the originating bank will typically retain an on-balance sheet asset, the "seller's interest," that is necessary to permit investors to receive regular and predicable payments during the life of the securitization. The bank, of course, holds capital for this on-balance sheet asset.

The NPR proposes to impose a capital charge against the off-balance sheet assets sold into a securitization ("managed assets") if the securitization structure includes an early amortization feature. The charge would be triggered as the amount of excess approaches the early amortization trigger.[7] As the three-month average excess spread declines, a higher and higher percentage of assets sold into the securitization trust would be converted into on-balance sheet assets and then subjected to a capital charge.

The Roundtable agrees that this approach is superior to simply imposing a flat charge on managed assets. However, any such capital charge should take into account measures that banking organizations may take to mitigate risks, including the development of liquidity plans to ensure the banking organization has alternative sources of funding in the event of an early amortization and the existence of third party commitments and guarantees. Further, the Roundtable is concerned that the proposed credit conversion factors are too high in light of the actual risk of credit losses to the bank in the event of an early amortization. The capital rules should not require a bank to hold more capital for assets sold into a securitization than for assets retained on their books.

K. Small Business Loans

The NPR does not change the current 100 percent risk-weight for small business loans, but the preamble states that the agencies are exploring various options to permit qualifying small business loans to be assigned a 75 percent risk-weight, but only if the banking organization's aggregate exposure to that borrower is $1 million or less. Other requirements include the need for a personal guarantee by the business owner, the full collateralization of the exposure, and restrictions on the length of the amortization period, and similar criteria.

Under the Standardized Approach, small business loans qualify for preferential capital treatment, and we urge that U.S. institutions receive comparable treatment. The Roundtable is concerned that the suggested regulatory qualifications may be unnecessarily stringent, thus limiting the usefulness of the reform. For example, the $1 million cap is lower than the limit imposed under the Standardized Approach, which currently equates to over $1.3 million. We would hope that the agencies would also review the other proposed criteria to provide more flexibility in this area.

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[7] The "excess spread" is an account funded by interest payments that are in excess of the amount needed to pay investors. The excess spread account serves as a buffer to provide a source of funds when cardholder payments are insufficient, in any particular month, to make all required payments to security holders.

L. Multifamily Residential Mortgages, Other Retail Exposures, Loans 90-Days Past Due, Commercial Real Estate

The NPR is not proposing any changes in the current treatment of multifamily residential mortgages, other retail exposures, loans 90 days past due or commercial real estate exposures. However, the NPR noted that the agencies are still interested in receiving comments on methods that would increase risk sensitivity for retail exposures, particularly through the use of credit assessments, such as the borrower's credit score or other measure of the ability to service debt. The Roundtable believes that the risk sensitivity of the Basel I-A proposal would be significantly enhanced by differentiating retail exposures by risk. To ease regulatory burden, we suggest that a number of methods for achieving this differentiation should be offered, thus providing depository institutions the ability to implement the standard in the least burdensome manner. For example, risk-weight could be adjusted based on the borrower's credit score, debt-to-income ratio, or in the case of collateralized loans, the LTV ratio.

Conclusion

The NPR contains many useful proposals that will help improve the current Basel I capital standards. However, some of the proposals could be further enhanced to improve the correlation between risk and capital, to reduce regulatory burden, and to lessen competitive concerns inherent in a two-system approach to capital. In addition, all of the options included in the international Accord should be made available in the U.S. In particular, the Standardized Approach, as described in the Accord, should be an option that a bank of any size could select for purposes of credit risk. Likewise, any internationally authorized methodology for determining Operational Risk should be available for Basel II mandatory institutions.

The Roundtable appreciates the opportunity to comment on the joint NPR and supports your efforts to provide for a more risk sensitive capital framework and a reduced regulatory and paperwork burden for our financial institutions. If you have any questions, please contact me at the Roundtable at (202) 589-2413.

Sincerely,

Richard M. Whiting
Executive Director & General Counsel