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March 26, 2007

Mr. Robert E. Feldmann, Executive Secretary  
Attention: Comments/Legal ESS  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20492

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

Mr. Feldmann:

I am pleased to comment on the Notice of Proposed Rulemaking (“NPR”) issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (together, the “Agencies”) regarding proposed revisions to the Agencies’ existing domestic risk-based capital rules.

I am a Senior Vice President & Deputy Risk Officer of Sterling Bank, a \$4.3 Billion community bank headquartered in Houston, Texas. I believe it is important that the Agencies adopt a multi-tier approach to risk-based capital guidelines to ensure that “capital regulations are appropriately risk sensitive and that such regulations continue to evolve over time as best practice within the industry is enhanced.” That the Agencies are considering “alternatives” and are soliciting opinion in this regard is important. Many have argued that banks like ours should have the option to remain under the existing risk-based capital guidelines, and we are again pleased that the NPR provides this option.

We strongly believe that regulatory capital requirements should be more closely aligned with risk to enhance the safety and soundness of the banking system. Exposures that have higher risk should require more capital; and, conversely, lower risk exposures should require less capital. A one-size-fits all capital charge of 8 percent for all risk exposures, and 4 percent for mortgages in light of the problems recently identified in the mortgage industry, is not a truly risk sensitive capital standard. In an appropriately risk sensitive capital regime, capital will either be higher, or lower, relative to risk.

The two NPR proposals that the agencies have submitted for industry comment with regard to revising risk-based capital standards, both contain requirements that are not appropriately risk

sensitive. Both appear to require more capital than the existing Accord in certain instances, and certainly a higher capital level than the 2004 International Framework. We believe that the best way forward at this point is the full adoption and implementation of the 2004 International Framework. We would urge the agencies to abandon the so-called Basel 1A proposal, and, instead, offer the availability of all three approaches contained in the 2004 International Framework: 1) Standardized, 2) Foundation IRB, and 3) Advanced IRB. We do not believe that the proposed regulatory capital regime as outlined in the NPR, the Basel 1A proposal, is sufficiently risk sensitive nor do we believe that it would necessarily enhance the safety and soundness of the banking system. In some instances it calls for an increase in current capital requirements that could be unnecessarily punitive. As proposed, it would also increase regulatory burden when compared to the Standardized Option in the 2004 International Framework.

We also support the agencies proposal that certain community banking organizations have the option to remain on the current regulatory capital framework. Many of these banks have risk metrics sufficient for their needs and choose to hold excess capital and a more complex regulatory capital regime would not be suitable for their management structure and risk profile.

With regard to Basel II, the 2004 International Framework, that was developed by the Basel Committee with the active input of the U.S. agencies over a 6-year period, it contains the necessary elements that enhance the safety and soundness of financial institutions: (i) new capital standards; (ii) enhanced supervision; and (iii) increased market discipline through additional public disclosures. With respect to capital, Basel II enables financial institutions to adopt one of two categories for risk weighting credit exposure: the “Standardized” approach and the internal ratings-based (“IRB”) approach. The IRB approach includes two methodologies for the estimation of various risk components: the “Foundation” approach and the “Advanced” approach. As initially proposed by the agencies, the Basel II ANPR only considered the implementation of the Advanced approach in the U.S. However, the Standardized and Foundation IRB approaches are expected to be adopted by many non-U.S. banks. And, it has been suggested that the Standardized option be made available here in the U.S.

The 2004 International Framework is superior to the U. S. proposals for AIRB and 1A since it provides a range of options for determining the capital requirements for credit risk and operational risk so that banks, subject to the approval of their primary supervisor, can adopt an approach appropriate to their risk profile and the markets in which they operate. The Framework is also designed to encourage continued improvement in risk management practices. It promotes a more forward-looking approach to capital regulation by encouraging banks first to identify the risk they face, and then develop a commensurate management approach from the options available in the Framework. As a forward-looking approach, the 2004 Framework was specifically designed to have the “capacity to evolve with time.” The U.S. proposals significantly lack this distinctive and most important characteristic.

Moreover, when the Framework was released in 2004, the Basel Committee stated that, “this evolution is necessary to ensure that the Framework keeps pace with market developments and advances in risk management practices, and the Committee intends to monitor these

developments and to make revisions when necessary.” We are very concerned that the U.S.’s continued divergence from the 2004 Framework could prevent further innovation in industry risk management practices.

It is also quite possible that failure to adopt the full International Framework could have the unintended effect of creating a very uneven playing field, from a competitiveness standpoint, across the entire domestic spectrum of community, midsize, and large banking companies. Indeed, we fear that the so-called 1A proposal, as put forth in the NPR, could result in significant pricing disparities among various size banks for both credit and non-credit products. As a result, a greater degree of consolidation could occur within the U.S. domestic market, and at a much faster pace. This development could lead to reduced competition among U.S. domestic banks and lessen the availability of credit to business and retail customers alike. Unfortunately, the 1A proposal could increase, rather than decrease, the level of competitive inequity among U.S. banks.

The Standardized Option in the 2004 Framework will be less burdensome to implement than the proposal known in the U.S. as Basel 1A. The risk weight for mortgage exposures is reduced from 50 percent to 35 percent under the Standardized Option, which is preferable to developing a formula tied to LTV or some other, or multiple, functions as suggested in the 1A proposal. Likewise, a 75 percent risk weighting for small business loans is preferable for the same reason. Clearly, for mortgage products and small business loans, the Standardized Option would be simpler to implement and be less burdensome as a result.

For institutions that choose the Standardized Option, the Basic Indicator Approach should be available to assess capital for operational risk, subject to supervisory approval.

With regard to wholesale credits, the 1A proposal includes a risk weight of 200 percent for unrated credits while the Standardized Option risk weights these credits at 100 percent. We strongly oppose the 200 percent risk weight. In addition, would argue that the implementation of such a proposal would greatly disadvantage mid-sized community and regional banks. As you must know, for these institutions, the vast majority of their commercial exposures are not rated. Again, the Standardized Option recognized the inequity of requiring a higher risk weight for unrated commercial exposures. For these reasons, the Standardized option in the 2004 Framework is superior to the 1A proposal.

The major components of the IRB approach are a classification of exposures into internal risk rating categories, with two alternative versions (the Foundation approach and the Advanced approach) for assigning inputs into the risk assessment for various categories of assets. Those inputs are generally: probability of default (“PD”), loss given default (“LGD”), exposure at default (“EAD”) and maturity (“M”).

Under the Foundation approach, banks provide their own estimates of PD associated with each of their borrower grades, but generally use supervisory estimates for the other relevant risk

components, *i.e.*, LGD, EAD and M. Pursuant to Basel II, a bank must demonstrate to the satisfaction of its supervisor that it meets certain minimum requirements at the outset and on an ongoing basis in order to be eligible to use the Foundation approach. Many of these requirements are in the form of objectives that a qualifying bank's risk rating systems must fulfill. The focus is on banks' abilities to rank order and quantify risk in a consistent, reliable and valid fashion.

The overarching principle behind these requirements is that rating and risk estimation systems and processes provide for a meaningful assessment of borrower and transaction characteristics; a meaningful differentiation of risk; and reasonably accurate and consistent quantitative estimates of risk. Furthermore, the systems and processes must be consistent with internal use of these estimates.

The Federal Reserve Board issued guidance on internal risk rating systems (SR 98-25) in 1998 that has since been adopted by many within the industry. In many ways, this guidance served as a key input into the early development of the Basel II International Framework. The Foundation IRB approach should be and must be available to banks in the U.S.

As you should be aware there are a large number of small banks that choose to hold excess capital and believe that they are already unduly burdened by an overly complex regulatory system. Since institutions must apply, and receive approval from a primary regulator, to adopt one of the three options in the 2004 International Framework, it should not be necessary for institutions remaining on the existing risk-based capital guidelines to notify their regulator. That is, banks choosing to remain under the current capital regime may do so without incurring additional cost or regulatory burden. Moreover, the regulatory agencies currently have the authority to require any institution to increase capital levels or improve risk management capabilities under the existing regulatory framework.

As the agencies are well aware, there remain a number of major uncertainties surrounding implementation of the Basel II Framework in the U.S. As the February 2007 Government Accountability Office (GAO) Report stated, "The banking regulators have differing regulatory perspectives, which has made reaching consensus on the proposed rule difficult." The GAO Report recommended that, "Increased transparency going forward could reduce ambiguity and respond to questions and concerns among banks and industry stakeholders about how the rules will be applied, their ultimate impact on capital, and the regulators' ability to oversee their implementation."

A possible solution to reaching a consensus would be that an industry/inter-agency task force be created to work jointly to develop appropriate risk parameter specifications and to "resolve on-going implementations issues surrounding Basel II." It is important at this point, to move forward on issues where consensus exists.

Below, we have attempted to answer the 22 questions included in the NPR.

Question 1: The Agencies welcome comments on all aspects of these proposals, especially suggestions for reducing the burden that may be associated with these proposals. The Agencies believe that a banking organization that chooses to adopt these proposals will generally be able to do so with data it currently uses as part of its credit approval and portfolio management processes. Commenters are particularly requested to address whether any of the proposed changes would require data that are not currently available as part of the organization's existing credit approval and portfolio management systems.

*We support the adoption of the June 2004 International Capital Framework (Basel II) that allows the option of 3 possible alternatives: 1) Standardized, 2) Foundation IRB, and 3) Advanced IRB. We also support the option of allowing small, non-complex community banking organizations to remain under the current risk-based capital framework, as suggested in the NPR.*

*Regarding data availability and portfolio management systems, many institutions are currently undergoing systems' upgrades. Most banks have undertaken improvements to their systems for risk management purposes primarily to improve internal risk management practices, but also with the objective of moving to a more risk sensitive regulatory capital framework as outlined in Basel II. We are currently engaged in a systems' upgrade to enable compliance with one of the three options outlined in the Basel II Framework.*

Question 2: The Agencies seek comment on all aspects of the proposal to allow banks to opt in to and out of the proposed rules. Specifically, the Agencies seek comment on any operational challenges presented by the proposed rules. How far in advance should a banking organization be required to notify its primary Federal supervisor that it intends to implement the proposed rule? If a banking organization wishes to "opt out" of the proposed rule, what criteria should guide the review of a request to opt out? When should a banking organization's election to opt in or opt out be effective? In addition, the Agencies seek comment on the appropriateness of requiring a banking organization to apply the proposed Basel IA capital rules based on a banking organization's asset size, level of complexity, risk profile, or scope of operations.

*We supports the option of allowing small, non-complex community banking organizations to remain under the current risk-based capital framework, as suggested in the NPR. However, we recommend that the Basel IA capital rules be replaced with the June 2004 International Capital Framework. The goal of the 2004 Framework was to promote improved risk management practices and it therefore provides a natural framework for migration of risk management capability from Standardized to Advanced. The Basel IA proposal does not allow for improvement in risk management practices and it is for this reason that we recommend the adoption of the 2004 Framework. Under that Framework, institutions must apply for treatment under the three approaches 12 months prior to adoption and maintain a parallel run period of one year. The 2004 Framework does not expressly state when an option might or might not apply to an institution based on asset size. It simply assumes that more robust internal risk management systems are better able to identify risk and thereby assign appropriate capital and those institutions are properly incented to improve their risk management practices. We believe that the 2004 Framework contains the right incentives for continued improvements in risk management and that individual institutions should have the option to choose which option best suits their needs.*

*Arbitrary classifications by asset size or option availability should not be written into the Framework since it is not included in the International Accord. Moreover, the U.S. agencies have ample supervisory authority to require institutions to adjust capital requirements based upon risk.*

Question 3: The Agencies seek comment on whether these or any other new risk weight categories would be appropriate. More specifically, the Agencies are interested in any comments regarding whether any categories of assets might warrant a risk weight higher than 200 percent and what risk weight might be appropriate for such assets. The Agencies also solicit comment on whether a 10 percent risk weight category would be appropriate and what exposures should be included in this risk weight

*We strongly oppose the 200 percent risk weight in the Basel IA proposal for unrated exposures. Moreover, we would argue that if such a proposal were implemented, it would greatly disadvantage mid-sized and regional banks since the vast majority of the commercial exposures these institutions hold are unrated. Indeed, under the Standardized option in the Basel II Framework, unrated exposures are 100 percent risk rated.*

Question 4: The Agencies solicit comment on all aspects of the proposed use of external ratings including the appropriateness of the risk weights, expanded collateral, and additional eligible guarantors. The Agencies also seek comment on whether to exclude certain externally rated exposures from the ratings treatment as proposed or to use external ratings as a measure for all externally rated exposures, collateral, and guarantees. Alternatively, should the Agencies retain the existing risk-based capital treatment for certain types of exposures, for example, qualifying securities firms? The Agencies are also interested in comments on all aspects of the scope of the terms sovereign, non-sovereign, and securitization exposures. Specifically, the Agencies seek comment on the scope of these terms, whether they should be expanded to cover other entities, or whether any entities included in these definitions should be excluded.

*Except for the very largest U.S. banks, most banks will have few commercial exposures with external ratings. However, many banks have developed very sound internal risk rating systems that they use to assign capital internally. The external ratings proposed in the Basel IA proposal should be aligned with those in the Standardized approach in the 2004 Framework, and the IRB Foundation option should be available.*

Question 5: The Agencies are considering whether to use financial strength ratings to determine risk weights for exposures to GSEs, where this type of rating is available, and are seeking comment how a financial strength rating might be applied. For example, should the financial strength rating be mapped to the non-sovereign risk weights in Tables 1 and 2? Should these ratings apply to all GSE exposures including short- and long-term debt, mortgage-backed securities, collateral, and guarantees? How should exposures to a GSE that lacks a financial strength rating be risk weighted? Are there any requirements in addition to publication and on-going monitoring that should be incorporated into the definition of an acceptable financial strength rating?

*We recommend the same treatment for GSE exposure as is included in the Standardized Option of the 2004 International Framework.*

Question 6: The Agencies also seek comment on whether to exclude certain other externally rated exposures from the ratings treatment as proposed or to use external ratings as a measure for additional externally rated exposures, collateral, and guarantees. Should the proposed ratings treatment be applicable for direct exposures to public sector entities or depository institutions? Likewise, should the proposed ratings treatment be applicable to exposures guaranteed by public sector entities or depository institutions, and to exposures collateralized by debt securities issued by those entities?

*Yes, externally rated exposures to public sector entities and financial institutions should be included in the risk-weighting system for regulatory capital. However, the risk-weights outlined in the Standardized Option of the 2004 International Framework should be utilized instead of the proposed risk-weights included in 1A.*

Question 7: The Agencies seek comment on all aspects of using LTV to determine the risk weights for first lien mortgages.

*We recommend the adoption of a simple 35% risk weight for mortgage products as is included in the Standardized Option of the 2004 International Framework.*

Question 8: The Agencies seek comment on this treatment and other methods for risk-weighting these privately-issued mortgage-backed securities, including the appropriateness of assigning risk weights to these securities based on the risk weights of the underlying mortgages as determined under Table 3.

*We do not support a separate risk-weighting scheme for privately-issued mortgage-backed securities. We believe that all securitized transactions should be treated equally. Securitized transaction should carry the rating assigned by the rating agency, and assigned to a commensurate risk-weight as outlined in the Standardized Option of the 2004 International Framework.*

Question 9: While the Agencies are not proposing to use LTV and borrower creditworthiness to risk weight mortgages, the Agencies may decide to risk weight first lien mortgages based on LTV and borrower creditworthiness in the final rule. Accordingly, the Agencies continue to seek comment on an approach using LTV combined with credit scores for determining risk-based capital. More specifically, the Agencies seek comment on: operational aspects for assessing the use of default odds to determine creditworthiness qualifications to determine acceptable models for calculating the default odds; the negative performance criteria against which the default odds are determined (that is, 60-days past due, 90-days past due, etc.); regional disparity, especially for a banking organization whose borrowers are not geographically diverse; and how often credit scores should be updated. In addition, the Agencies seek comment on determining the proper credit history group for: an individual with multiple credit scores, a loan with multiple borrowers with different probabilities of default, an individual whose credit history was analyzed using inaccurate data, and individuals with insufficient credit history to calculate a probability of default.

*See response to question #7.*

Question 10: The Agencies seek comment on whether there are other circumstances under which LTV should be adjusted for risk-weight purposes.

*See response to question #7.*

Question 11: The Agencies request comment on all aspects of PMI including, whether PMI providers must be non-affiliated companies of the banking organization. The Agencies also seek comment on the treatment of PMI in the calculation of LTV when the PMI provider is not an affiliate, but a portion of the mortgage insurance is reinsured by an affiliate of the banking organization.

*See response to question #7.*

Question 12: The Agencies seek comment on the proposed risk-based capital treatment for all mortgage loans with non-traditional features and, in particular the proposed approach for mortgage loans with negative amortization features. The Agencies also seek comment on whether the maximum contractual amount is the appropriate measure of the unfunded exposure to loans with negative amortization features. The Agencies seek comment on whether the unfunded commitment for a reverse mortgage should be subject to a similar risk-based capital charge.

*The agencies have recently issued guidance for non-traditional mortgage products and additional guidance is not necessary at this time. Moreover, the agencies have authority under Pillar II to require additional capital for portfolios that may have higher risk profiles.*

Question 13: The Agencies request comment on the appropriateness of the proposed risk-based capital treatment for HELOCs including the burden of adjusting LTV as the borrower utilizes the HELOC.

*See response to question #7.*

Question 14: Accordingly, the Agencies seek further comment on all aspects of the use of LTV and borrower creditworthiness to determine the risk weight for a junior lien mortgage.

*As stated earlier, we recommend the adoption of a simple 35% risk weight for mortgage products as is included in the Standardized Option of the 2004 International Framework.*

Question 15: The Agencies continue to seek comments on an alternative approach that would apply a single CCF of 20 percent to all commitments, both short- and long-term (that are not unconditionally cancelable), and the advantages and disadvantages of such an approach.

*We support the adoption of a single CCF of 20 percent as is proposed in the Standardized Option under the 2004 International Framework.*

Question 16: The Agencies solicit comment on the appropriateness of the 4.5 percent excess spread trapping point and on other types and levels of early amortization triggers used in



securitizations of revolving exposures that should be considered, especially for HELOC securitizations. The Agencies also seek comment on whether a flat 10 percent CCF is a more appropriate capital charge for revolving securitizations with early amortization features.

Question 17: The Agencies seek comment on this or other approaches that might improve the risk sensitivity of the existing risk-based capital rules for small loans to businesses.

*We support the adoption of a 75% risk weight for small loans to businesses, as is included in the Standardized Option of the 2004 International Framework.*

Question 18: The Agencies remain interested in industry comments on any methods that would increase the risk sensitivity of the risk-based capital requirements for other retail exposures, particularly through the use of credit assessments, such as the borrower's credit score or ability to service debt. The Agencies are particularly interested in whether and how credit assessments might be applied consistently and uniformly in the determination of risk weights without creating undue burden.

*As stated above, we support the adoption of the risk weights outlined in the Standardized Option.*

Question 19: To what extent should the Agencies consider allowing Basel II banking organizations the option to calculate their risk based capital requirements using approaches other than the Advanced Internal Ratings Based (A-IRB) approach for credit risk and the Advanced Measurement Approach (AMA) for operational risk? What would be the appropriate length of time for such an option?

*We support the full implementation of the 2004 Framework, with all options available (Standardized, Foundation IRB, and Advanced IRB) subject to supervisory approval.*

Question 20: If Basel II banking organizations are provided the option to use alternatives to the advanced approaches, would either this Basel IA proposal or the standardized approach in Basel II be a suitable basis for a regulatory capital framework for credit risk for those organizations? What modifications would make either of these proposals more appropriate for use by large complex banking organizations? For example, what approaches should be considered for derivatives and other capital markets transactions, unsettled trades, equity exposures, and other significant risks and exposures typical of Basel II banking organizations?

*We do not support the adoption of the Basel IA proposal.*

Question 21: The risk weights in this Basel IA proposal were designed with the assumption that there would be no accompanying capital charge for operational risk. Basel II, however, requires banking organizations to calculate capital requirements for exposure to both credit risk and operational risk. If the Agencies were to proceed with a rulemaking for a U.S. version of a standardized approach for credit risk, should operational risk be addressed using one of the three methods set forth in Basel II?

*All of the options available under the 2004 International Framework for calculating operational risk should be available to U.S. institutions, subject to supervisory approval.*

Question 22: What additional requirements should the Agencies consider to encourage Basel II banking organizations to enhance their risk management practices or their financial disclosures, if they are provided the option to use alternatives to the advanced approaches of the Basel II NPR?  
*We believe that the regulatory agencies have ample authority to require regulated institutions to improve risk management practices.*

Again, we appreciate the opportunity to offer commentary on the NPR, and would be happy to answer any questions you may have.

Very Sincerely,

Terry B. Gunter  
Senior Vice President  
Deputy Risk Officer