January 18, 2006

Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Re: Comment on the banking agencies' Joint ANPR (Basel I-A); OCC Docket No. 05-16

Ladies and Gentlemen:

The undersigned financial organizations, all of which are national banking associations or corporate parents of such institutions, welcome the opportunity to comment on the proposed revisions to the existing U.S. risk-based capital rules as set forth in the Advance Notice of Proposed Rulemaking ("ANPR") jointly published by the federal financial regulatory agencies on October 20, 2005.

On behalf of institutions commonly referred to as "midsize national banks," the undersigned commenters include banks (or their parents) ranging in size from slightly less than $10 billion to well over $30 billion in assets. These institutions operate throughout the United States and compete daily with large internationally active banks, locally owned community banking organizations, and a variety of so-called "nonbank" financial institutions. They share the fundamental objective of most banks, which is to operate in a safe and sound manner while generating competitive returns for their shareholders. Not surprisingly then, they have followed the course of the development of Basel II closely, including the currently proposed revisions--commonly referred to as "Basel I-A"--to the original Basel Capital Accord.

We appreciate the diligent efforts of the financial regulatory agencies in revising and refining the capital regulations, most assuredly a painstaking task. It cannot reasonably be disputed that substantial revisions to the existing capital rules will have a significant impact on the banking industry, forever changing the manner in which depository

institutions operate. Just as the original Capital Accord was a venture into uncharted territory, bankers will find that the currently proposed revisions will take the industry where it never has been before. We hasten to add that this is not intended to suggest that the capital rules should not be revised. To the contrary, we are in agreement that Basel I has become a regulatory tool of limited use and is clearly in need of an update. We respectfully urge, however, that a reasonable degree of caution appropriately must be exercised when treading into the unknown with our financial system. Neither our nation's financial system, nor the systems of the numerous other nations with which and through which America's banks and other businesses engage in business every day, nor the international financial systems through which we, and our respective economic interests, all are intertwined, can afford a misstep. Consequently, as an industry we must be absolutely certain that the new capital regime "works" for all banks, large and small. It is with this concern in mind that the following comments are submitted.

The Proposed Multi-headed System

While not identified in the ANPR as a topic for which comment was specifically solicited, the proposed bifurcated/tripartite structure of the system of capital regulation in the U.S. is an aspect of the proposal that, we respectfully submit, deserves serious reconsideration. We believe that a risk-based capital regime that incorporates multiple approaches, each of which, when employing the same underlying data, may yield different results from the others, is fraught with issues that can only be detrimental to the banking system, and thus the economy of the nation, and it is a regime that we cannot support.

Like both the original Capital Accord ("Basel I") and Basel II, Basel I-A relies on the use of "risk weights," applied to various categories of bank assets in order to assign numerical values to depository institutions' "risk-weighted assets" and thereby measure and report the respective levels of risk to which banking organizations are subject. To be more specific, risk weights, according to a consultative paper introducing the original

Accord, are a proxy for the counterparty risk of a bank's exposures (e.g., loans).[1] Expressed as percentages, risk weights, when applied to an institution's exposures, will produce its risk-weighted assets (e.g., a $100,000 loan with a 50% risk weight will yield a $50,000 risk-weighted asset). Under Basel I, Basel I-A and Basel II, risk-weighted assets are used as a comparative tool in measuring bank capital levels. This is done by using an institution's ratios of tier one capital to risk-weighted assets, and total capital to risk-weighted assets, to evaluate its capital adequacy. These ratios, along with the leverage ratio, form the nucleus of capital regulation in the banking industry in the United States.

While we do not dispute the value and usefulness of risk-weighting as a tool for the measurement of the risk inherent in banking exposures, we strenuously object to the fact that the very same bank data will produce differing levels of risk-weighted assets, depending upon whether the data are evaluated under Basel I, Basel I-A, or Basel II. To be more precise, under the fragmented system of capital regulation proposed, banks with identical balance sheets will report differing levels of risk-weighted assets, depending upon which system of capital calculation they employ. As the level of an institution's risk-weighted assets increases, in comparison to its total assets, there is a corresponding increase in the level of risk to which the institution is perceived to be subject. For example, the same loan made to a corporate borrower, in the amount of $500,000, will have a different risk weight, and, therefore, will be reported as an asset with a different risk-weighted value, if measured under Basel I, Basel I-A or Basel II. That loan will have a 100% risk weight under Basel I, and thus, will be reported as a $500,000 risk-weighted asset by a bank operating under that system. Under Basel I-A, it will have a 75% risk weight and thus will be reported as a $375,000 risk-weighted asset. Under Basel II, the loan may have any number of risk weights, many of which may be lower than those under Basel I or I-A, and, hence, it may be reported as yet an even lower risk-weighted as-

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[1] *See, generally*, Bank for International Settlements, Committee on Banking Regulations and Supervisory Practices, *Proposals for international convergence of capital measurement and capital standards*, at 3, 9 and 10 (December 1987) (explaining why a "weighted risk ratio," in which capital is related to different categories of assets, weighted according to categories of relative riskiness, is the preferred method for assessing the capital adequacy of banks).

set.[2] If, as in the original Accord, risk weights are intended to be a proxy for the counterparty risk of a particular exposure, the question inevitably arises whether, in making identical loans to the same borrower, the banks operating under Basel I and Basel I-A will have taken on more risk than the bank operating under Basel II. That would appear to be the inescapable conclusion, yet we can discern no rational or reasonable basis to justify such a result, nor would it appear to further any desirable supervisory objective.

Such anomalous results, spread across institutions' entire loan portfolios, are bound to create substantial differences in the total levels of risk-weighted assets reported from bank to bank, wholly without regard to whether there are in fact any appreciable qualitative differences in the content or composition of the institutions' respective underlying asset portfolios. These disparities unavoidably will create the appearance that the banks that operate under Basel I and Basel I-A are subject to greater risk than the Basel II banks, because of the higher levels of risk-weighted assets that necessarily will be reported under Basel I and Basel I-A. A further consequence is that, if the Basel I, Basel I-A and Basel II banks all have the same amounts of capital, the capital ratios of the Basel II bank will easily exceed, at least in appearance, those of the Basel I and Basel I-A banks, since risk-weighted assets serve as the denominator in the capital-measurement ratios of tier one capital to risk-weighted assets, and total capital to risk-weighted assets.

As demonstrated by this example, the point that we want to impress, not only upon the banking agencies but also upon the financial community and the investing public, is that, as result of the multiple systems of capital regulation that are proposed, the ability to compare the financial strength of banks that operate under different capital regimes will largely be lost. A Basel I bank, for example, cannot be compared to a Basel II bank, on the basis of capital relative to risk, because their differing methodologies for calculating risk will yield different results, even if the underlying data are identical. To compound the issue, as QIS-4 demonstrated, it is a certainty, at least as things stand now, that the institutions operating under Basel II will arrive at differing conclusions as to their

[2] This is because, under Basel II, the risk weight is derived from "inputs" based on the bank's own internal data. Depending upon the value of the inputs, which are estimated from the bank's data, numerous resulting risk weights can be calculated.

risk-weighted assets, even if using the exact same balance-sheet data.[3] Thus, not only will it be impossible to compare banks' relative financial strength when they operate under different capital-measurement systems, but those banks that operate under Basel II cannot reasonably or meaningfully be compared, one to another, on the basis of capital relative to risk, because of the variances that result from the varying "inputs" used under Basel II.

Accordingly, we question the value and the utility of a multi-headed capital regime that yields differing results from one bank to the next. How will investors determine which bank "has it right" and is in the best capital position? Further, we question how the inevitable resulting disparities will affect regulatory peer-group comparisons, which, if unchanged, would have banks operating under different versions of Basel in the same peer groups. In contrast, we believe that a capital regime where the risk weight assigned to an asset does not differ depending upon the bank that holds it would be a much more viable system, and one that we could support. Moreover, we believe such a capital regime–even with variations for banks of different sizes–would be free of much of the controversy, confusion, uncertainty, and, it must be said, lack of industry support, that surround the multi-headed system currently under consideration.

In addition, our experience with the present risk-based capital framework–and the accompanying costs and complexities that are required for proper observance and administration of that framework–suggests that the applicability of Basel I-A should begin at an asset level greater than $500 million. The discussion that follows highlights some of the more critical factors that, in our view, necessitate an increase in the size of the institutions that will be subject to the new regime, and we urge that the agencies, first, give careful consideration to identifying the types of institutions that properly should be made

[3] Former Federal Deposit Insurance Corporation Chairman Donald E. Powell recognized these issues, in recent Congressional testimony on Basel, when he said that "the results [of QIS-4] indicate a wide dispersion of results at both the banking organization and portfolio or business line level, including material differences in capital requirements for identical, or virtually identical, credit exposures." Hearings on the Development of the New Basel Capital Accords, Before the United States Senate Committee on Banking, Housing, and Urban Affairs (November 10, 2005).

subject to it, and, second, take appropriate measures to make clear the scope and applicability of any proposal that is adopted as final.

The Leverage Ratio

Although, again, it is a matter not specifically addressed in the ANPR, the ongoing debate over the future of the leverage ratio is yet another matter upon which we are compelled to offer comment. As a group, we are united in our support for the continued use of the leverage ratio in evaluating and prescribing bank capital levels.

As discussed hereinabove, there exist many uncertainties with respect to the proposed capital regime under consideration. The leverage ratio can be a vital tool in mitigating the undesirable effects of these uncertainties, and we believe that its continued use as a supervisory tool will contribute to the stability of the banking system. Furthermore, in light of the foregoing discussion of the differing results in risk-weighted capital measures that are produced under Basel I, Basel I-A and Basel II, only the leverage ratio will allow bank capital levels to be compared on an "apples-to-apples" basis.

Additionally, former FDIC Chairman Powell, during recent testimony on revisions to the Basel Capital Accord, pointed out that "the regulatory capital requirements set by the Basel II framework are very sensitive to individual banks' subjective assessments of risk."[4] One unfortunate consequence of this aspect of Basel II is that it opens the door for institutions to report misleading or unreliable capital levels by using faulty assumptions or otherwise "gaming" the system. Hence, inappropriate and unwarranted reductions in capital may be experienced by undeserving Basel II banks. The leverage ratio, however, while perhaps not as "sophisticated" as the risk-based ratios, is not subject to manipulation by intentional distortion or to error resulting from faulty assumptions. The leverage ratio, therefore, appropriately may serve as a reliable alternative–and a useful means of testing and verification–to evaluate whether the capital levels of institutions op-

[4] *Id.*

erating under Basel II remain sufficient. Accordingly, we urge that the leverage ratio be retained by the regulators as a component of required bank capital levels.

The Treatment of One-to-Four-Family Mortgages: First and Second Liens

It is proposed that, under Basel I-A, risk weights for first-lien one-to-four-family mortgage loans could be set according to the loan-to-value ratio ("LTV") of the particular exposure. We view favorably a more flexible risk-weighting approach that would incorporate LTV. However, while LTV is an important indicator of the likely level of loss in the event of default, in our collective experience, it has not been as reliable as consumer credit history in predicting loan performance. Our experience tells us that credit risk in the mortgage-lending context can be effectively managed only by being attentive to both LTV and the mortgagor's credit score. In addition, we fear that a system that would focus primarily on LTV may have the unintended consequence of encouraging lenders to adopt an asset-based lending strategy, rather than one that gives due consideration to all dimensions of credit quality and collateral quality. Hence, with respect to this aspect of the proposal, we believe the adoption of a system that relies on factors other than the secondary source of payment (i.e., collateral value) would better serve the financial community.

The proposal also touches upon the need for periodic updates of collateral valuations, as well as other measures, in arriving at the risk weights for first-lien one-to-four-family mortgage loans. Periodic updates of collateral valuations, and of credit scores, are appropriate to ensure proper and ongoing risk assessments, which, in turn, are important to lenders' maintenance of adequate levels of capital. We accordingly support this concept. At the same time, however, we believe the frequency and timing of such updates should not be arbitrary. Depending upon the required frequency with which such updates must be obtained, the need to obtain them could add substantially to an institution's operating costs, while, if they are not properly timed, yielding little benefit in the way of enhancing credit-risk assessment. We therefore submit that the timing and frequency of

updating collateral valuations and credit scores would best be left to the informed judgment of individual banks, acting on the basis of their knowledge of such factors as property type, market volatility and other local conditions, the mortgagor's financial status, and the particular risk dimensions of the bank's exposures.

Turning to second-lien one-to-four-family mortgage loans, we believe that the proposed treatment of such assets under Basel I-A cannot reasonably be reconciled with the proposed treatment of first-lien one-to-four-family mortgage loans. By way of explanation, under Basel I-A a sliding scale of risk weights is proposed for first-lien mortgage loans on one-to-four-family properties. This sliding scale would assign a risk weight of 50% for loans having an LTV in the range from 81% to 90%, and a risk weight of 100% for loans that have an LTV from 91% to 100%. In contrast, for stand-alone second-lien mortgage loans (where the institution does not hold the first lien) the risk weight proposed under Basel I-A is 100% - but only if the LTV, considering the combined amount of the loans secured by both the first and second liens, does not exceed 90%. We respectfully question whether it is appropriate or justifiable, when a first-lien mortgage loan having an 81%-90% LTV would be risk weighted at 50%, that a second-lien mortgage loan with a combined LTV (with the first lien) also of 81% to 90% would have a 100% risk weight. Under this aspect of the Basel I-A proposal, a second mortgage loan made to a borrower who holds more equity in the security property can be assigned a higher risk weight than a loan made to another borrower with less equity in the property, for the sole reason that the loan is labeled as a second mortgage.

Considering the tax treatment afforded second mortgages, they often make financial sense for borrowers and, thus, represent appropriate uses of debt–and profitable business for lending banks–at lower overall cost to the borrower than would be incurred in using alternative sources of financing. Rather than focusing on the ratio of total debt to collateral value resulting from such loans, as Basel I-A does in the case of first-lien loans, it appears that the proposal would saddle second-mortgage loans with higher risk weights simply because they are in a subordinate position. We suggest, as we did in respect to first-lien mortgages, that a system that considers the total credit-risk assessment process,

including factors such as credit score, LTV, debt-to-income ratio, etc., would be a more reasoned and more useful approach to assigning risk weights to such exposures. Such an approach would better reflect the ability of banks to control and predict the risks associated with second-mortgage loans, without penalizing an institution for extending a second-mortgage loan to a qualified and financially astute borrower.

In a related area, it is proposed under Basel I-A that when a second-lien mortgage is held by the same institution that holds the first lien, the two could be combined and risk-weighted as if the combined total were a first lien only (a carry-over from existing regulations). While in theory such a practice sounds reasonable, it fails to recognize that many institutions do not retain first-lien mortgage loans after their origination, choosing instead to securitize them or otherwise sell them in the secondary market. As a result, we believe that, more often than not, the holder of the second lien will not be the same as the holder of the first lien. We therefore suggest that this treatment of second-mortgage loans, while well-intentioned, is likely to have little practical effect, given current banking practices.

Treatment of Commercial Real Estate

Commercial Real Estate ("CRE") loans under Basel I-A are treated in a different manner compared to the way that such loans are treated under Basel II. Risk weights are assigned to CRE loans under Basel II in the same manner as they are assigned for other loans to general corporate borrowers. That is, banks under Basel II assign risk weights for CRE loans using their own internal data, and those data are utilized through application of the same formulas used with respect to corporate and C&I loans. Consequently, CRE loans can have risk weights well below 100%. The treatment by Basel II of CRE loans in the same manner as corporate loans is supported by a Federal Reserve White Paper on the subject, which concludes that there is insufficient empirical evidence to justify treating CRE loans as more risky than C&I or corporate loans. Despite this finding, CRE loans are treated under Basel I-A as more risky than corporate and C&I loans. For exam-

ple, under Basel I-A, a *corporate or C&I* loan can have a risk weight lower than 100% if the borrower receives an external credit rating of "investment grade," or if the lender's total exposure to the borrower is less than $1 million. There is, however, no corresponding provision respecting *CRE* loans that would allow any of them to be assigned a risk weight less than 100%.

We question why CRE lending should be treated the same as corporate and C&I lending under Basel II, but treated as more risky under the Basel I-A proposal. This disparate treatment would seem to create precisely the type of competitive imbalance that the Basel I-A initiative was intended to correct.

Additionally, as it is proposed, Basel I-A would assign risk weights to acquisition, development and construction ("ADC") loans that are higher than the 100% risk-weighting currently assigned to such credits. But simply to declare all ADC loans as higher-risk and, therefore, needing additional capital support, would be a measure wholly unsupported by the experience of prudent lenders who have established successful and mutually beneficial relationships with experienced businesses engaged in ADC activities. Admittedly, the proposed Basel I-A (like Basel II) would permit assignment of a reduced risk weight for any such loan that is "backed by substantial borrower equity." Such treatment, in essence, represents a determination by the regulators that, unless an ADC loan is backed by substantial equity of the borrower, it is inherently laden with significantly more risk than other loans. Although there are many similarities among ADC loans, there are significant differences in the risk levels between, for example, 100% speculative construction loans and loans for construction of a facility that will be occupied by an owner-operator; similarly, there is no realistic basis for equating the risk level of a loan made to finance land acquisitions for purely speculative purposes over the next five years with that of a loan made to acquire land for a 100% pre-leased retail center, or to put the same risk weight on a loan for the development of a parcel for a 350-lot residential project as on a loan to buy a parcel to be used for the last 50 lots of a successful three-phase project. Accordingly, we disagree with the presumption in Basel I-A that all ADC loans necessarily and inherently carry higher levels of risk. This presumption cannot be recon-

ciled with our collective lending experience, and thus, we oppose the treatment that is proposed to be given to such loans.

Multifamily Residential Mortgages

As stated in the ANPR, multifamily residential mortgage loans are currently assigned a risk weight of 100%, and certain seasoned multifamily residential loans can qualify for a risk weight of 50%. The ANPR requests comment on what factors should be considered in assigning a lower risk-weighting to such a loan. While there are many factors that contribute to satisfactory performance in multifamily lending, our experience consistently has been that the most important factors are the management experience of the borrower and the borrower's overall debt-service coverage. These characteristics are extremely important, given that they reflect the borrower's time in the business, the capability of its management, and the levels of potential stress that could result from changes in net operating incomes, vacancies, and increasing interest rates.

While it may be difficult to incorporate into the capital regulations a reliable means of measuring or quantifying such factors as "time in the business," we believe that provision can be made, with relative ease, to include debt-service coverage as a meaningful component of capital evaluation under Basel I-A. Consequently, we believe it should be accorded careful consideration as a factor in determining those multifamily mortgage loans that would qualify for a 50% risk weight.

Past-Due Loans

According to Basel I-A, once a loan reaches the 90-day past-due point, it is likely that the lending bank will incur a loss on that loan. To offset this risk, the proposal suggests assigning loans that are 90 days or more past due, or that are in nonaccrual status, to a risk-weight category greater than 100% (i.e., either 200% or 350%). While delin-

quency certainly is a relevant factor in the probability of default on a loan, it is not a factor that has a high degree of relevance to the amount of loss that an institution will incur in the event of default. Thus, we can discern no rational basis for concluding that a loan that is 90 days past due will result in a loss equal to 200%, or 350%, of the amount of regulatory capital that would be required for the same loan if it were performing as agreed.

External Credit Ratings

The ANPR proposes to allow certain exposures to be risk-weighted based on external credit ratings assigned to the obligor by a Nationally Recognized Statistical Ratings Organization ("NRSRO"). Such risk weights would range from 20% to 350%, depending on the obligor's external credit rating. While we wholeheartedly support efforts by the agencies to build flexibility into the risk-weighting process, the vast majority of our borrowers are unrated. Consequently, we believe this aspect of the proposal will do little to ameliorate the competitive advantage held by Basel II banks.

This is especially true in the area of commercial lending, where both Basel II banks and non-Basel II banks compete for the same loans. Currently (under the original Accord), corporate loans are risk-weighted at 100%. The ANPR provides that loans to corporate borrowers could be assigned a risk weight lower than 100%, based on the obligor's external credit rating (e.g., a loan to an obligor with a BBB rating would be assigned a risk weighting of 75%). This would be a welcome development, if in fact there were reason to believe it would have any real-world effect. Unfortunately, the *vast majority* of commercial obligors do not have external credit ratings and, thus, loans made to them by non-Basel II banks will be risk-weighted at 100%. On the other hand, the majority of risk weights on commercial loans that are made by Basel II banks will likely be below 100% (because Basel II banks will assign risk weights on such loans based on their own internal data, regardless of whether the borrower has an external credit rating, and because they have more rated credits). For all of these reasons, therefore, we expect that

this proposal, to permit risk-weighting on the basis of NRSRO ratings, will do little to level the playing field.

Of further concern is the fact that, while over 130 credit-rating agencies exist, only five have been designated as NRSROs by the SEC: Moody's; Standard & Poor's (S&P); Fitch; Dominion; and AM Best (which rates insurance companies only). Moody's and S&P have a virtual stranglehold on the credit-rating industry, so much so that members of Congress recently introduced legislation designed to break up the so-called credit-rating "duopoly" held by these two. The criteria for becoming an NRSRO are murky at best, and, as a result, it is unlikely that other ratings agencies will be available to compete with Moody's or S&P, or otherwise will be available to the banking sector. Consequently, should this aspect of the proposal be adopted, banks would be inextricably bound to Moody's and S&P. This would not seem to be in the best interest of the banking industry, nor would it be consistent with promoting and maintaining the competitive marketplace that, experience has shown, over the long term best serves both the providers of financial services and their customers. Incorporating the external ratings of NRSROs into the agencies' capital standards, therefore, could have the effect of unnecessarily subjecting the operation of those standards to the effects of business practices that, in the view of at least some industry observers, are anticompetitive.

Numerous scholars have expressed the view that credit ratings lag behind the market and provide little if any predictive information. For example, on June 29, 2005, Frank Partnoy, Professor of Law at the University of San Diego, testified before a subcommittee of the U.S. House of Representatives:

> [T]here is overwhelming evidence that [credit] ratings are of scant informational value. Particularly since the mid-1970s, the informational value of ratings has plummeted. There have been multiple unexpected defaults and sudden credit downgrades in recent years. The recent short-list includes Orange County, Mercury Finance, Pacific Gas & Electric, Enron, WorldCom, and most recently General Motors and Ford. Numerous academic studies have shown

> that ratings changes lag the market and that the market anticipates ratings changes.[5]

In an earlier work of Professor Partnoy's, published in the Washington University Law Review, he asserted:

> [S]tudies by financial economists and anecdotal evidence . . . suggest that credit ratings have become less accurate over time, and that credit spreads of bonds in particular rating categories have changed dramatically. James Van Horne, a professor of finance at Stanford, has concluded that "[w]hile the assignment of a rating for a new issue is current, changes in ratings of existing bond issues tend to lag behind the events that prompt the change." Kenneth Lehn, a professor of business administration at the University of Pittsburgh (and an advisor to Moody's) has concluded that only seventy-five percent of the ratings process is based on statistical information and equations, and that twenty-five percent is subjective. Frank Packer's initial research for the Federal Reserve Bank into the movement of sovereign bond yields indicates that yields typically decline several days before the agencies act on a rating, suggesting the agencies lag behind the market.[6]

Accordingly, we submit, these and other issues warrant serious consideration by the financial regulatory agencies as they consider whether to interject NRSROs, and their credit ratings, into the agencies' regulation of institutions' capital levels. Moreover, to the extent that Congress may consider action in this area, the prospect of legislative activity concerning the rating agencies may be further cause for financial regulators to exercise scrutiny over any measure that would involve them, however indirectly, in regulation of capital levels.

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[5] Legislative Solutions for the Rating Agency Duopoly: Hearings on H.R. 2990, Before the United States House of Representatives Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises (June 29, 2005) (Testimony of Frank Partnoy, Professor of Law, University of San Diego School of Law).

[6] Frank Partnoy, *The Siskel and Ebert of Financial Markets?: Two Thumbs Down for the Credit Rating Agencies*, 77 Wash U. L.Q. 619, 658-659 (1999).

One countervailing factor, however, is that the ANPR also proposes to permit assignment of a lower risk weight for "certain business loans under $1 million on a consolidated basis to a single borrower." This lower risk-weighting, which would be assigned regardless of the existence of an external credit rating, would be 75%. A lower risk-weighting assigned to such exposures would indeed alleviate some of the concerns that we express herein. In the case, however, of aggregate exposures of $1 million or more to an unrated commercial borrower, there is no proposal in the ANPR that would allow assignment of a risk weight of less than 100%. Accordingly, and in contrast with their treatment under Basel II, these loans will continue to be risk-weighted at 100%, despite the actual risk (or the lack thereof) that such loans in fact pose to the lending institution.

Additional Comments

In conclusion, there are several additional matters that we believe worthy of comment. First, if banks are to obtain the full benefit of Basel I-A, it is likely that some–if not most–of them will have to assume additional costs. In order to take advantage of certain forms of collateral that, under the Basel I-A proposal, may be used to reduce risk weights on certain exposures, banks would be "required to have collateral management systems that can track collateral and readily determine the value of the collateral that the banking organization would be able to realize." For some institutions, this may necessitate the hiring of additional personnel, in addition to absorbing the increased costs likely to be incurred by all banks that operate under Basel I-A. Similarly, tracking LTVs and credit scores on numerous loans, for the purpose of assigning risk weights (for example, in the one-to-four-family or retail-lending contexts), will add to a bank's operating costs. In addition, although the proposed increase in the number of risk weights may enable banks to arrive at more accurate risk determinations, adding too many new weights would drive up operating costs, which could more than offset the benefit represented by any such increase in accuracy. We urge regulatory authorities to exercise care to ensure that the cost of admission to Basel I-A is not so great as to prevent a significant number of banks from

taking full advantage of its provisions. Otherwise, the implementation of Basel I-A may negatively affect the profitability of the industry, while producing questionable benefits.

Others among the various mechanisms provided for under Basel I-A, as it is proposed, also will add to the growing (and seemingly overwhelming) day-in-and-day-out regulatory obligations of banks. The ever-multiplying duties imposed upon banks as a result of such new or enhanced laws and regulations as the Bank Secrecy Act, the Sarbanes-Oxley Act, and the privacy and other provisions of the Gramm-Leach-Bliley Act, have all contributed to lost time and losses in productivity. We urge the banking agencies to remain cognizant of this circumstance in revising our capital rules.

Furthermore, we fear that the increased costs and the additional work-force that would be necessitated by the proposed revisions to the capital rules may lead to greater consolidation in an industry largely–and increasingly–dominated by a handful of banking organizations. For example, a large bank operating with reduced capital requirements under Basel II may find it much easier to acquire a smaller, non-Basel II institution because of the "capital savings" that can be realized by adding the non-Basel II bank's assets and capital to its balance sheet, and then applying Basel II's formula. Likewise, in their efforts to compete with Basel II banks, smaller institutions may find that the benefits of economies of scale are necessary to realize fully the benefits available under the provisions of Basel I-A, or to "step up" to Basel II.

Finally, we would also add that, if a multi-headed system of capital regulation is adopted in the U.S., we would strenuously urge that a bright-line system of demarcation be adopted and implemented to separate those banks operating under the original Accord, those operating under Basel I-A, and those operating under Basel II. The process of creating these demarcations should take account of all appropriate factors, such as institutions' relative resources, asset size, and potential peer-group comparisons. We believe it would be unfair to compare a bank operating under a "less sophisticated" version of Basel to one operating under one of Basel's more advanced approaches.

We appreciate the opportunity to submit these comments, and we stand ready to assist the banking agencies, in whatever way we can, as they pursue this most important endeavor.

Respectfully submitted, this 18th day of January, 2006, by:

[Signature Pages Follow]

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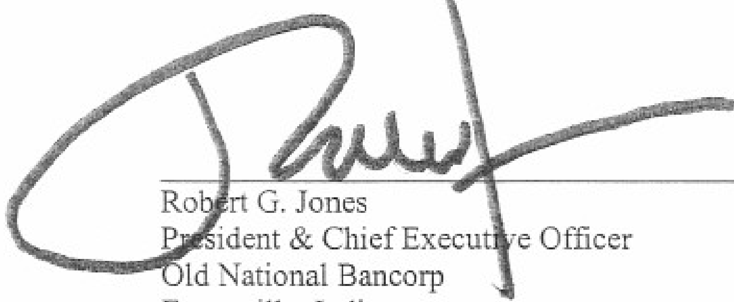

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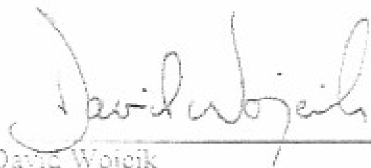

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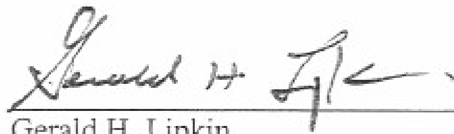

Gerald H. Lipkin
Chairman, President & Chief Executive Officer
Valley National Bank
Passaic, New Jersey