October 27, 2008

By electronic delivery

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Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS-2008-0002
regs.comments@ots.treas.gov

Re: **OCC** Docket No. OCC-2008-0006; **FRB** Docket No. R-1318; **FDIC** RIN #3064-AD29; **OTS** Docket No. OTS-2008-0002: Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework

Ladies and Gentlemen:

This comment is in response to the joint notice of proposed rulemaking of 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 (collectively, the "Agencies") regarding a new risk-based capital framework (standardized framework) based on the standardized approach for credit risk and the basic indicator approach for operational risk described in the capital adequacy framework titled "International Convergence of Capital Measurement and Capital Standards: A Revised Framework" (New Accord) released by the Basel Committee on Banking Supervision. 73 Fed. Reg. 43982 (July 29, 2008).

Underlying the proposed rule is the premise that a bank can accurately estimate a borrower's probability of defaulting ("PD"), the loss the bank would incur in the event of a borrower's default ("LGD"), and the amount of the bank's exposure to a borrower at the time of default ("EAD"). This premise is highly questionable. Whether bankers can make reliable, comparable, and transparent estimates of these parameters to forecast expected and unexpected credit losses is unproven and, based upon historical periods of credit stress, doubtful.

One of the lessons of the current residential mortgage and securitization crisis is that such estimates are volatile, and the prior experience that is used to derive such models is often not an indication of future experience. Credit evaluation is not a hard science and is impacted by subjective changes in borrowers' motivations as well as changes in product characteristics (i.e., loan-to-value ratios, amortization schedules, collateral value, etc.). All of these changes have an immense impact on the level of inherent credit risk. The weakening of underwriting standards alters the risk profiles of both borrowers and exposures; however, these changes in standards are difficult to control for in data series.

For example, the weak underwriting standards, such as excessive loan-to-value ratios and inadequate analysis of a borrower's capacity to repay a loan, that led to the commercial real estate crisis of the late 1980's and early 1990's were repeated in the past decade in the residential mortgage market. Both situations led to a common outcome, namely a massive number of defaults and greatly increased loss severity due to the depreciation of the collateral.

Both of these periods of extreme credit stress were preceded by periods of historically low credit losses in these products. Based on these earlier periods of low realized credit risk, lenders excessively relaxed credit underwriting standards and lowered loan pricing in response to the low perceived risk. As a result, when the cyclical downturn in sales activity occurred and the illiquidity of the underlying assets became apparent, defaults and loss severity sharply escalated and resulted in the failure of undercapitalized lenders. Credit models were widely used to approve transactions, structure securitizations, and determine pricing in the residential mortgage and securitization market. These credit models did not predict the level of inherent risk that led to the current realization of massive defaults and losses.

The same estimates that are the foundation of the proposed rule were deployed by the external rating agencies to underestimate the credit risk associated with collateralized debt obligations and mortgage backed securities. Under the proposed rule, bankers will be making the estimates of the PD, LGD, and EAD parameters. However, there is no assurance that bankers' estimates will be any more reliable than those of the rating agencies. Moreover, the proposal does not contain any mechanism to prevent another unsafe and unsound lending activity to follow the underwriting excesses of commercial real estate and residential sub-prime and Alt-A lending.

The proposed rule also sets forth an uneven playing field. Small banks will have an objective standard of risk weights, and large banks will have essentially a voluntary standard based on unreliable, non-transparent, and self determined estimates. In addition to the inequity of small banks and large banks holding different levels of regulatory capital for an exposure of comparable risk, two unrelated large banks are very likely to hold different levels of capital for an exposure of comparable risk based upon differences in their parameter estimates. Can the Agencies ensure that comparable exposures at two different large banks will receive the same level of regulatory capital? If not, this proposal is a capital standard in name only.

While a risk sensitive capital standard is a worthy goal, an objective, transparent, and uniform standard is highly preferable to a framework built on unreliable, non-transparent estimates determined by bank management.

Very truly yours,

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