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January 18, 2006 via email

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Re: **FDIC** RIN 3064–AC96; **FRB** Docket No. R-1238; **OCC** Docket No. 05–16; **OTS** Docket No. 2005–40; **ANPR on Revising Domestic Capital Adequacy Guidelines**; 70 Federal Register 61068; January 18, 2006

Ladies and Gentlemen:

The Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision (collectively, the "Agencies") have issued an Advance Notice of Proposed Rulemaking (ANPR) on concepts to make the existing domestic capital adequacy guidelines (Basel I) more risk sensitive (that is, develop "Basel IA"). While the Agencies have made more than twenty changes to the Basel I capital standard since its adoption in 1989, this is the first discussion of a broad revision of the guidelines. The American Bankers Association (ABA) appreciates the opportunity to comment on this ANPR. ABA, on behalf of the more than 2.1 million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership – which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks – makes ABA the largest banking trade association in the country.

The Agencies issued this ANPR because they have agreed with other national supervisors to change the capital guidelines for the largest, internationally active institutions in the proposed Basel II Capital Accord. Since Basel II is expected to result in significant changes in risk-based capital required for our nation's largest banks and savings associations, many bankers from other institutions have expressed considerable concern about competitive inequities that could result from adoption of Basel II without updating Basel I.[1] To address those concerns, the Agencies make a number of suggestions in the ANPR for increasing the risk sensitivity of Basel I without significantly increasing the burden on smaller banks to develop complex risk monitoring and reporting systems. ABA is deeply appreciative of the Agencies' prompt response to industry concerns.

I. General Comments

The ANPR presents several concepts with an intent of improving the risk sensitivity of risk-based capital without significantly increasing the burden on banks. **Overall, ABA is very supportive of the concepts outlined in the ANPR**, many of which reflect improvements in the banking industry's assessment and control of credit risk that have have been developed in the years since the adoption of Basel I. With the adoption of Basel II, the domestic capital standard will no longer be part of an international accord, so the moment is ripe for revisions. After all, the one-size-fits-all formula that was developed for internationally active banks in the major industrial countries never corresponded well with the actual performance of most banks operating in local markets across the nation. Since the risk weights were developed in the late 1980s, exposures for various on- and off-balance-sheet activities have evolved with banking markets, regulatory and legal practices, and risk-management tools. In particular, the current risk weights for good quality home mortgages, commercial real estate loans, ratable business credits, and well-collateralized or risk mitigated credits are now much too high based on industry experience. Further, ABA believes that there are now additional ways for the capital rules to recognize improvements in credit risk management, which we present in the Specific Comments below. Some of ABA's recommendations are as conceptual as those proposed by the Agencies, and we envision a continuing process of refining these concepts with more specific discussion and proposals to come.

Our comments were developed through banker discussions led by an ABA Working Group composed of bankers from very small banks to multi-billion dollar instititions. Based on the range of banks consulted, our responses reflect a call for a flexible capital adequacy standard. Our smaller institutions told us that many of the concepts in the ANPR, such as the use of external credit ratings, simply have no meaningful relevance to their balance sheets. In fact, our smallest banks, which typically hold high capital levels, suggest that **the Agencies need to retain Basel I as a floor for noncomplex banks and savings associations.** Larger institutions see in the proposal some recognition of their better credit-quality assets, but overall they believe that the concepts as presented would primarily affect the largest institutions that are not mandatory Basel II participants.

We conclude that **the Agencies should explore additional concepts in risk assessment, internal modeling and credit controls, and recognition of risk mitigation to increase the risk-sensitivity of the capital standard.** An improved standard should recognize banks' more sophisticated credit risk analysis and risk classification for lines of credits and exposures. **ABA also believes that the Agencies should continue to review the components of capital, particularly whether to include additional identifiable intangibles.**

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[1] See, for example, ABA letter to the Agencies dated April 14, 2005, from James D. McLaughlin.

II. Specific Comments

II.A. Increase the Number of Risk-Weight Categories

The Agencies ask whether an increase in the number of risk-weight categories from the current zero, 20, 50, 100, and 200 percent, adding four new risk-weights of 35, 75, 150, and 350 percent, would make Basel IA more risk sensitive without unduly adding to the regulatory burden. **Our bankers support the concept of additional risk-weight categories, but only if the result is a meaningful change in risk sensitivity.** However, without specifics as to which assets will receive these risk weights, they are not prepared to endorse the proposed risk weights. Additionally, a number of our bankers feel that these risk weights would still overstate the low-risk of their high quality credits. Thus, **ABA recommends that the Agencies should refine the concept of additional risk weight categories in Basel IA.**

At the same time, a significant number of small banks indicate that they expect to continue to hold high capital levels, as they do now, so that any change to the capital calculation would be just more regulatory burden. Therefore, **ABA recommends consideration of retaining Basel I as a base capital standard for banks with relatively standard balance sheets.**

ABA also recommends that the Agencies consider an alternative approach to simplify the capital calculation while addressing the competitive inequities: **Basel IA should allow banks to use the same nine asset categories as Basel II's Foundation Internal Ratings-Based Approach, but peg the capital requirement to some ceiling above the median capital requirement actually achieved by the Basel II banks.** That is, if Basel II banks peg 30-year fixed rate mortgages at an overall risk-weight of 30 percent, then Basel IA banks would peg such assets at, for example, 20 percent more, or a 36 percent risk-weight. Given the large amount of total industry assets held by the mandatory Basel II banks, their risk-weight results would appear to reflect overall asset quality in the industry, which is the basis of this approach. ABA's Working Group is willing to meet with staff of the Agencies to explore further how this might be implemented.

II.B. Use of External Credit Ratings

ABA supports the use of external credit risk ratings for the risk-weighting of assets, as proposed in the ANPR. However, our bankers feel that two issues must be considered further. First, only the largest banking firms appear to hold meaningful amounts of securities rated by a Nationally Recognized Statistical Rating Organization (NRSRO), or loans to firms that are similarly rated. Even multi-billion dollar banks hold very little externally rated credits in their security or loan portfolios. Except for the very largest institutions, bank portfolios consist almost exclusively of unrated government and mortgage securities. Thus, the external ratings proposal simply does not currently appear to apply to enough banks to make a difference, and ABA sees little to no effect at present of this concept in the ANPR.

Second, the ANPR proposes that securities rated BB+ or lower would be risk weighted higher than unrated assets. This could have the perverse effect of tempting banks to shed lower rated investments for unrated investments, which could actually raise overall risk profiles. The ANPR also asks for methodologies to assign risk weights to unrated exposures. While our bankers have no specific suggestions at this time, **ABA recommends that the Agencies and the industry continue to work on identifying such alternative methodologies, in order to address the problems of higher risk weights for low-rated securities and marginal impact on most banks.**

II.C. Expand Recognized Financial Collateral and Guarantors

The ANPR suggests expanding the list of recognized collateral to include short- and long-term securites (corporate and asset- and mortgage-backed debt) that are rated investment grade by an NRSRO, or issued or guaranteed by a sovereign central government that is rated investment grade by an NRSRO. This is helpful, if not very relevant for most banks. While **ABA supports such recognition of credit ratings for capital risk weights**, as with the proposal to use external credit ratings, our bankers report very few loans secured by externally-rated securities.

The ANPR also suggests expanding the scope of guarantors recognized in the capital standard to include any entity whose long-term senior debt is NRSRO-rated investment grade. It suggests using a ratings-based approach for determining the risk weight applicable to a recognized guarantor. Again, **ABA supports recognition of guarantors with investment grade rated debt**; however this slightly expanded list of eligible guarantors would affect few to none of our bankers' loans.

Therefore, while Basel IA should recognize the lower risk in assets with the guarantors described in the ANPR, our bankers suggest that **Basel IA also needs to recognize an effective risk mitigant used by many banks: personal guarantees of financially sound persons and entities within a bank's market.** ABA recommends that the Agencies look at additional measures of creditworthiness of guarantors, such as net worth measures of the guarantor in relation to the debt guaranteed, and the guarantor's credit score. Where guarantors represent significant levels of net worth, their risk-weights should be lowered by cross-guarantees provided by these guarantors. One common form of this is in commercial and industrial lending when a borrower's debt is cross-guaranteed by affiliates of the borrower. When the total asset size of the guaranteeing entities or their net worth is significantly more than the exposure, then the exposure should be lower risk-weighted.

II.D. One-to-Four Family Mortgages: First and Second Liens

The ANPR suggests increasing the number of risk categories for these mortgages to reflect the credit risk mitigation effects of varying loan-to-value (LTV) ratios, as in the chart at right. **Our bankers strongly support such an approach**, which reflect some of the last two decades' considerable improvements in underwriting and credit risk analysis for home mortgages.

LTV Ratio	Risk Weight
91-100%	100%
81-90%	50%
61-80%	35%
≤ 60%	20%

The ANPR also asks whether, if this approach is adopted, LTV ratios should be updated periodically. Bankers are concerned about the time and cost of maintaining up-to-date valuations for calculating the LTV, noting that it is unclear from the ANPR if annual valuations would be required. Uniformly our bankers oppose such frequent reassessment, particularly in relation to Home Equity Lines of Credit (HELOCs). **ABA recommends that annual revaluations should not be required.** The benefits from such frequent revalutations would be more than outweighted by the concommitant costs. **Any mandatory revaluations for risk-based capital purposes should be based on some local index of property values, or changes in the property assessment rolls for determining the current LTV**. However, if a bank collects curent valuations then it should be allowed to use these in its LTV calculations.

Bankers also note that the LTV approach does not recognize several other credit risk drivers that they believe should be recognized as well. As an example, bankers note that there is no credit given for the "seasoning" of the loan. Bankers report very little default in loans that have been performing on the books of the bank for two, three or more years. They also note that the last decade saw rapid acceleration of the pace of home mortgage prepayments, which significantly lessened lender exposure to adverse changes in values. Accordingly, **ABA recommends that the Agencies consider reducing the risk weight of seasoned loans further than proposed in the ANPR.**

The ANPR asks whether loan-level or portfolio private mortgage insurance (PMI) should be used to reduce LTV ratios for the purposes of determining capital requirements. **Our bankers report that both forms of PMI are effective credit risk mitigants, and they support both uses of PMI to reduce LTV ratios for capital requirements.**

The ANPR asks if there are risk-weight floors for certain mortgages subject to PMI, especially higher-risk loans and novel products. Our bankers have no recommendations on this, but note that the Agencies recently proposed Guidance on Nontraditional Mortgages appears to specifically require higher capital and loss reserve allocations, particularly for risk-layered nontraditional mortgages. **ABA recommends that the Agencies defer consideration of this issue until after they review the comments to be filed on the proposed Guidance.**

ABA notes further that the Agencies do not propose credit risk weighting based on credit scores. However, credit scoring has been a major factor in mortgage underwriting credit analysis for more than a decade. In fact, recent Federal Reserve research appears to justify significant reductions in risk weight, even for high LTV mortgages, if the credit score of the borrower is high.[2] **ABA recommends that the Agencies consider this research and the value of credit scores and propose additional reductions in mortgage risk weights.** The experience here is broad and tested, and should be reflected in the risk weightings

Stand-Alone Second Mortgage Liens and Home Equity Lines of Credit (HELOCs)

The ANPR also proposes a risk weight higher than 100 percent for stand-alone second mortgage liens and for HELOCs when the bank holds a second lien mortgage but not the first lien and the LTV at origination for the combined loans exceeds 90 percent. Bankers have not noticed any appreciable increase in default or loss on these loans. Nor do they see a noticeable difference whether the first mortgage is held or not. More fundamentally, it would be hard to justify treating second mortgage liens and HELOCs more harshly than otherwise similar yet unsecured consumer loans. Moreover, many banks keep first mortgages on a mortgage servicing system and junior liens on a consumer loan system. As a result, they cannot easily identify juniors where the first is not held.

If, nonetheless, higher risk weights are applied, ABA recommends that the weighting should be no more than 150 percent and secured consumer loans should not be weighted higher than otherwise similar but unsecured loans. If the overall LTV declines, the risk-weight should be matched with the table for first liens. Nevertheless, we emphasize that experience is the best guage of risk and should be the chief factor in determining the risk weighting.

II.E. Multi-family Residential Mortgages

Multifamily residential mortgage loans are currently risk-weighted at 100 percent unless they qualify for a 50 percent weight based on prerequisites for seasoning, amortization, maturity, loan-to-value, and others. The ANPR asks for suggestions with supporting data on qualifications for multifamily

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[2] See Table 1 in Paul Calem and James Follain, "The Asset Correlation Parameter in Basel II for Mortgages on Single-Family Residences," Board of Governors of the Federal Reserve, Nov. 2003.

mortgages that warrant lower risk weights, such as small size, history of performance, or low loan-to-value ratio.

Bankers feel that the requirements to achieve a 50 percent risk weight are unnecessarily restrictive. Their individual institutions' experience indicates that even this risk weight is high, based on low loss experience of quality credits in this category. They recommend that a loan-to-value ratio of no more than 80 percent should warrant the lower risk weight, without additional qualifications. As above, regular reassessment of individual collateral values should not be required, but instead could be based on local market indices. None of the Working Group bankers has data to support a lower risk weighting.

II.F. Other Retail Exposures

The ANPR solicits suggestions for determinants to discriminate risk weightings among consumer, automobile, credit card and other types of retail loans. More specifically, it asks what risk drivers – for example, loan-to-value, credit assessments, and/or collateral – and risk weights would be appropriate for these types of loans. It also asks about the effects of the use of risk drivers on the availability and price of credit for lower income borrowers.

Bankers believe that the risk-based capital standard needs to acknowledge the value of credit scores as indicators for performance on retail credit. Many bankers have practically and usefully employed credit scores to reduce the risk of retail and, as discussed below, small business lending. ABA recommends alignment of the regulatory standard with industry practice by reflecting credit scores in capital calculations as well.

However, **ABA recommends that the borrower's credit score at origination should be used without periodic updates.** Virtually all of the supporting research data are based on credit scores at origination. They were designed and tested to be reliable indicators – at the time of origination – of the likely performance of the borrower over the life of the loan. Most banks that use credit scores do not normally revise them over the life of the loan due to the time and cost of doing so. Nor does experience show a need for revision. The paperwork burden would not warrant the benefit if bankers have to regularly repull and record credit scores.

Some Agency staff have indicated that the 350 percent risk weight under consideration could apply to past-due and subprime credits. Bankers are concerned by this suggestion, as the Agencies have tried earlier and encountered considerable difficulties in defining "subprime" in a way that is not overly broad and restrictive of credit.

II.G. Short-Term Commitments

There is currently no capital charge against credit commitments with original maturities under one year or that can unconditionally be cancelled at any time by the lender. The ANPR asks whether there should be a risk-based capital charge against noncancelable exposures of this duration, calculated using a ten percent credit conversion factor. Longer term commitments would remain at fifty percent. As an alternative, the ANPR offers a conversion factor of twenty percent for all noncancelable commitments, both short-term and long-term.

ABA supports the application of a capital charge against short-term, noncancelable commitments so that 365 days is not a "bright line" cutoff. For the same reason, our **bankers believe that a single**

conversion factor for noncancelable commitments of all maturities – but no higher than twenty percent – would correspond with risk exposure experience.

II.H. Loans Ninety Days or More Past Due or in Nonaccrual

The ANPR asks whether capital should be assigned against exposures that are 90 days or more past due and those in nonaccrual status, with the extent of exposure reduced by reserves allocated to cover potential losses on that exposure. **ABA opposes the imposition of a capital charge for past due or nonaccrual exposures as redundant**. Bankers feel that this suggestion is misguided. If a banker has properly reserved for potential losses, then the exposure does not present additional risk requiring higher capital.

Banks are required to provision into reserves, a capital surrogate, an amount equal to the probable losses less recoveries on their loan portfolios. In fact, reserving practices have been closely scrutinized in recent years to make sure that banks do not reserve more or less than net anticipated losses. Additionally, the overall exposure retains a capital charge with corresponding risk weighting. If a change in the capital rules imposes yet a higher capital charge then it would be triple-counting the exposure, which would result in a senseless contraction of credit.

A higher capital charge would be warranted only if reserves are believed to be inadequate to cover net losses. This would only be the case if the bank's reserving practices were deficient. In this case, supervisory-directed correction of the reserving practices would be warranted, not additional capital.

An example demonstrates how inappropriate this change would be. Suppose that a loan against a residential property is overdue. The bank, following good credit management practices, would then encourage the borrower to catch up on loan payments or, failing that, ultimately foreclose on the collateral – and in either case reevaluate the amount of reserves appropriate for the loan. If the loan is then appropriately reserved for, why should it be placed in a higher risk weight category?

II.I. Commercial Real Estate (CRE) Exposures

All commercial real estate (CRE) loans currently face a 100 percent risk weight. The ANPR recommends a higher risk weight for acquisition, development and construction (ADC) CRE loans that either (1) do not satisfy the Interagency Real Estate Lending Standards or else (2) are not supported by a substantial amount of borrower equity for the duration of the facility (*e.g.*, fifteen percent of the completion value).

ABA believes that it is a worthwhile goal to develop a risk-weighting scheme for CRE exposures. The scheme should recognize the significant differences in types of CRE loans as well as underwriting and lender expertise in CRE lending. The scheme should also reward those banks that understand and manage the risk, so that it encourages other banks to improve underwriting and risk mitigation practices. We believe that the proposed approach will not adequately capture the different types of CRE loans and risk control techniques used by banks.

We note that much business lending is collateralized with CRE – in fact, many banks have asked for additional risk mitigation in the form of CRE collateral in strengthening underwriting standards over the last decade. All small business loans currently receive a 100 percent risk weighting, and some may qualify for lower weightings as discussed below. We therefore are surprised that the ANPR would seek to increase the risk weighting for stronger business loans – except for individual banks where there is supervisory concern.

The ANPR discloses that the Agencies have "longstanding supervisory concerns" in this area. However, the capital standards applicable across the entire banking industry are not the right place to address these concerns. When supervisors are concerned that an individual bank has an excessive CRE concentration, or is extending such credit in an unsound manner, they should address these concerns through the supervisory process and not through national capital standards. On January 11, the Agencies released a proposed guidance on "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices." Taking into consideration industry comments, the revised CRE guidance would be a better way than capital charges to deal with the supervisory concerns. While ABA will comment on the CRE guidance in a separate letter, we request that the Agencies note the importance of ensuring compatibility of that guidance with the capital standards.

Bankers are also concerned about the potential impact on business lending of this ANPR. Many bankers indicate that a considerable portion of their business lending is ADC, and that these loans will fluctuate in and out of the Agencies' proposed exemption, making monitoring of this considerably more burdensome. The result could be a significant negative impact on business credit availability and thus on local economies, without making the overall capital regime materially more reflective of real conditions.

We therefore recommend that ADC loans continue to be assigned a 100 percent risk weight, or be allowed a lower weighting when classified by workable risk drivers. The ANPR also asks for other indicators for CRE loan risk weighting and appropriate weights. **ABA recommends the use of loan-to-value ratios and credit assessment, as proposed – with the previously discussed caveats. We recommend that loan seasoning be considered as well.**

Additionally, the suggestion highlights one of the major defects in the ANPR: no recognition of bankers' internal risk monitoring and credit management. Our bankers believe that the Agencies need to broaden their approach to Basle IA to include some recognition of the internal risk controls, either through review of past performance in bank examinations or even review of the bank's own credit risk analysis, which is often more sophisticated than anything reflected in the examination.

II.J. Small Business Loans

Small business loans, less accepted guarantees and collateral, currently receive a 100 percent risk weight. The ANPR proposes a 75 percent weighting for qualified business loans under $1 million on a consolidated basis to a single borrower. To qualify, the loans would have to fully amortize over seven years or less, perform according to the loan contract, be fully collateralized, and be originated according to underwriting policies that include an acceptable credit and collateral assessment. Alternatively or additionally, the loan would qualify based on a credit assessment of the business principals and their ability to service the debt.

ABA supports a lower risk weight for good quality small business loans and both alternatives as improvements in risk scoring. However, we believe that these alternatives may be further improved. The $1 million cap is unduly restrictive, and we recommend that the limit be at least $5 million and indexed to inflation. We are also concerned that qualifications of seven-year amortization, personal guarantees, and full protection by collateral are overly restrictive and would significantly limit the applicability of this proposal while imposing major paperwork burdens.

The ANPR also solicits comments on other risk drivers for small business loans, including credit assessments, loan-to-value, collateral, and guarantees. Bankers report growing use of credit scoring of small business principals, especially in large banks in metropolitan areas. Accordingly, **ABA recommends that credit scores be considered as a discriminator for small business loan risk weighting.** While the usage may not turn out to be sufficiently widespread at present, our Working Group believes that such will be the case at some point in the future. **ABA further recommends that the age of the business or length of credit relationship should be factored into the risk weighting.**

II.K. Early Amortization of Revolving Credits Sold into Securitization

Credit card receivables and other revolving credits that are sold into a securitization structure are removed from the balance sheet of the originating bank. The bank will retain an on-balance-sheet asset, the seller's interest, so that investors can receive regular and predictable payments over the securitization life. The bank holds capital against its exposure, the part left on its balance sheet, but not the part sold. The ANPR raises concerns that the bank may be exposed to various risks in this process for which no capital is currently required. In particular, the ANPR considers the fact that many securitization programs provide for "uncontrolled early amortization" of the arrangement if the securitization runs into trouble, usually indicated by a decrease in the "excess spread" to a predetermined level. These early amortization provisions usually result in subordinating the payment of the seller's interest to protect the investors. The ANPR also notes that an early amortization event could result in limiting the originating bank's liquidity.

The ANPR seeks comment on whether, and in what form, to impose capital charges against securitizations of credit card accounts, and possibly other revolving assets. The Agencies feel that early amortizations in such securitizations present growing risks due to the increasing number of such transactions, and that these risks are not fully covered in their 2001 rulemaking on recourse and direct credit substitutes.[3] The ANPR proposes that capital could be assessed with a flat conversion factor (*e.g.*, ten percent) against off-balance-sheet receivables in securitizations with early amortization provisions, or alternatively could be based on key indicators of risk (*e.g.*, "excess spread" of interest receipts in excess of commitments to investors, delinquencies).

ABA opposes the imposition of a capital charge against early amortization of revolving credits sold into securitization. First, bankers from institutions with active credit card securitization facilities report that early amortization events are very infrequent, so that any capital assessment is expected to overcharge for the risk. Second, early amortization is a liquidity risk, not a credit risk, and thus would not be germane for risk-based capital requirements for credit risk. Third, a capital charge would likely make Basel IA securitizers uncompetitive with those under Basel II.

If, nonetheless, the Agencies decide that the investors' position in a securitization should bear a capital charge, then ABA recommends that the excess spread should determine risk weighting. This approach correlates more closely with risk exposure than a flat assessment. Moreover, the rule should take into account the credit quality of assets, third-party commitments and guarantees, and backup liquidity/funding arrangements.

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[3] 66 FR 59614-59619, Nov. 29, 2001.

III. Application of the Proposed Revisions

III.A. Basel I vs. Basel IA

The ANPR asks whether the Agencies should allow a bank to apply the existing risk-based capital framework, Basel I, below some asset-size threshold. It also proposes allowing a bank to choose among Basel I and Basel IA approaches for different segments of its risk-based capital calculations.

ABA recommends that the Agencies' goal of a more risk-sensitive standard balanced against the regulatory burden would best be served by allowing banks the flexibility to choose which system to adopt, Basel I, Basel IA, or Basel II. For many banks with relatively standard balance sheets, the existing Basel I rule is a prudent regulatory standard. For these banks, the regulatory and paperwork burden of adopting Basel IA, even though it could lower the capital requirement, would not be an efficient use of resources. For other institutions, the benefit may be worth the cost. However, at supervisor discretion, a relatively small bank could be judged sufficiently complex to mandate the use of Basel IA, just as some very large and complex banking firms will be required to adopt Basel II. Therefore, **ABA believes that the option to remain on Basel I should not be limited by a size threshold.**

Similarly, **ABA agrees that banks should be allowed to implement Basel IA in parts, and retain Basel I approaches for the rest of their operations.** This flexibility would help and encourage banks to phase into Basel IA over time. However, supervisors should have discretion to require use of Basel IA for sufficiently complex segments of the portfolio or operations.

III.B Transitional Floor for Basel II Adopters

For the first three years of adopting Basel II, banking institutions will be required to compute their risk-based capital requirement under both Basel II and the existing standard, and any reduction in risk-based capital will be tied to the existing requirement. The ANPR asks if the floor should be based on the existing Basel I framework or the new Basel IA standard.

ABA does not support a requirement for Basel II institutions to compute capital under the Basel IA framework. Basel II institutions currently compute risk-based capital under Basel I, and will soon shift to Basel II. Requiring these institutions to developing systems for Basel IA reporting and computation so that they can temporarily make an additional calculation under Basel IA would be a senseless and expensive regulatory burden. Instead, **ABA recommends that these institutions be given the option of using the Basel I or Basel IA as a transitional base**, so that each can individually decide whether the regulatory burden is worth its trouble.

IV. Concepts Not Covered in the ANPR

IV.A. Recognition of the Quality of Bank Risk Analysis

The Agencies should explore additional concepts in risk assessment, internal modeling and credit controls, and recognition of risk mitigation to increase the risk-sensitivity of Basel IA. An improved standard should recognize banks' more sophisticated credit risk analysis and risk classification for lines of credits and exposures.

Moreover, bankers have been forced to justify their risk assessment processes in setting loan loss reserves, with tight scrutiny from internal review, auditors and examiners. The risk-based capital scheme can simultaneoulsly improve risk sensitivity and reduce the regulatory burden by taking advantage of these processes.

Banks that have suitable data and internal modeling should be allowed to qualify exposures in any asset or exposure category for lower risk weights. Instead of the limited risk drivers specified in Basel IA, the determinants of risk should not be restricted. Instead, the risk drivers would be specified in the individual bank's modeling, as suits its markets. The burden would be on the bank to justify to examiners the validity of its data and model.

IV.B. Additions to Capital

As noted above and in our earlier letters, **ABA recommends that the Agencies continue to explore what assets should be viewed as components of capital.** For example, as markets develop for various forms of identifiable intangibles, these should be considered for inclusion in capital in the risk-based capital calculation.

One area where the potential for continuing competitive inequity exists is with regard to the capital treatment of specifically identifiable intangible assets. In this category there are two types of identifiable intangibles, Purchased Mortgage Servicing Rights (PMSRs) and Purchased Credit Card Relationships (PCCRs), that are: (i) common and substantial among banks in the Basel II size-range and (ii) not deducted from tier-one equity capital. Under the existing risk-based capital guidelines, these assets are instead assigned 100 percent risk weightings.

In addition to PMSRs and PCCRs, there is a third specifically identifiable intangible asset, Core Deposit Intangible (CDI), that is (1) common among all banks and (2) fully excluded from the calculation of tangible tier-one equity. In economic terms, this means owners of CDI must carry approximately 16½ times as much shareholders equity against this asset as owners of PMSRs and PCCRs under current regulatory capital guidelines. Under the proposed revisions to risk-based capital rules, owners of PMSRs and PCCRs would have the opportunity for further advantageous risk weighting if they are able to secure guarantees for these assets from investment grade-rated third parties. If such guarantees could be secured for PMSRs or PCCRs, the disparity in capital treatment between them and CDI would increase even further.

Market precedent already exists for guarantees of CDI value from investment grade-rated third parties. However, given CDI's full deduction from tier-one equity, owners of guaranteed CDI assets will get no regulatory capital benefit under the proposed rule. Under the proposed rule, the regulatory agencies are formally acknowledging the risk mitigating character of such guarantees, and, further, the agencies are willing to extend additional capital benefit to guaranteed PMSRs and PCCRs. In order to re-establish competitive parity between smaller and larger banks, we believe guaranteed CDI should be treated the same as guaranteed PMSRs and PCCRs provided that, in each instance, the CDI assets are contractually capable of sale separate from the bank.

V. Conclusion

ABA appreciates this opportunity to comment on the ANPR and supports the Agencies' efforts to provide for a more risk sensitive capital framework and a reduced regulatory and paperwork burden. If you have any questions, please contact Paul Smith or Robert Strand.

Sincerely,

Paul Alan Smith

Paul A. Smith
Senior Counsel

Robert W Strand

Robert W. Strand
Senior Economist