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January 18, 2006

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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:

This letter is submitted on behalf of Zions Bancorporation in response to the bank regulatory agencies' request for comment on their Advanced Notice of Proposed Rule-making ("ANPR") regarding Risk-Based Capital: Domestic Capital Modifications (so-called "Basel Ia"). The stated reasons for publishing the ANPR are "to update the risk-based standards to enhance the risk sensitivity of the capital charges, to reflect changes in accounting standards and financial markets, and to address competitive equity questions that have been raised about the implementation of Basel II in the United States."

Summary

(1) There is justification for requiring more sophisticated risk management processes in larger banks; however, this does not automatically imply a theoretical justification for allowing those processes to lead to lower capital ratio levels than those of smaller banks. However, Basel II is doing precisely that.

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(2) The ANPR will not rectify this problem. In fact, it appears that it may make it worse. Despite its apparent reduction in capital requirements in a number of lending categories, many of these areas are immaterial to most regional and community banks. The ANPR opens the possibility of reduced risk-based capital for only a subset of small and middle market business ("SME") lending, and indicates a bias toward more capital for commercial real estate ("CRE") lending; both of these lending activities are core to many community and regional banks today. This proposal seems at odds with the fact that the limited data from QIS 4 that has been made public seems to indicate that Basel II banks will enjoy a reduction in capital in those same areas—based on their lower risk.

(3) Even if the regulators "got it exactly right" with the final rule and established risk weights that perfectly captured the risk of today's underwriting practices and economic conditions, changes to either or both could quickly make them obsolete and incorrect. Any regulatory process to correct for this would inevitably lag the changing conditions significantly, whereas Basel II bank capital levels would evolve continuously with these changes. Thus, competitive inequities could quickly reemerge.

(4) There is only one way that this commenter can think of to materially improve the ANPR: Link capital standards in Basel Ia by loan category to the average capital levels by category of the Basel II banks. While there is no theoretical reason to do so (see #1 above), to make it politically saleable, this could be done with a slight "penalty" to compensate for the substantial cost to the Basel II banks of adhering to that standard. For example, if the average economic capital level calculated by Basel II banks for unsecured SME loans of good quality was 5.0%, adding a 2% premium to that would result in a 5.10% capital requirement by well-managed Basel Ia banks for that type of loan. If over time Basel II banks calculated economic capital rose to 6.0% for these loans, the requirement for Basel Ia banks would increase to 6.12%. This type of standard could be administered by regulatory agencies conducting a type of QIS every few years, and then publishing the results for a list of loan categories.

If something like this approach was adopted, Zions would support removal of the regulatory leverage ratio constraint. However, in the absence of a Basle Ia along these lines, Zions believes that the Leverage Ratio standard for all banks, at or close to its present level, should be maintained in perpetuity. In conjunction with Basel II this will have the effect of requiring much greater risk management sophistication on the part of large banks without giving them an overall capital advantage vis-à-vis other banks, reducing their systemic risk to the FDIC and economy, and at least partially neutralizing the competitive advantage they get from the rating agencies (see detailed comments below).

(5) If the regulators are unwilling to explore proposal "4" above, the only way to improve the ANPR from the perspective of most community and regional banks will be to give recognition to the most common risk mitigation techniques actually used by these banks in their core SME and CRE lending: personal guarantees, cross-collateralization, and loan-to-value ratios. The latter two, for example, may largely explain why CRE probability of default ("PD") and loss given default ("LGD") in the most recent downturn led to almost no losses, compared to substantial losses in the circa 1990 downturn. The regulatory agencies seem unwilling to recognize in theory or in practice the importance of these risk mitigants, even though Basel II banks will benefit from them greatly in their economic capital calculations.

Detailed Comments:

1. Zions suggests that in seeking to devise a modified risk-based capital standard applicable to non-mandatory Basel II banks in the United States, the agencies need to go back to insurance "first principles." In a banking environment, first loss risk is borne by the shareholders who provide most qualifying risk-based investment capital. In the second loss position are the non-depository creditors of the bank or bank holding company. In the third loss position are the non-insured deposit creditors of the bank. And in the final, and largest, loss position are the insured deposit creditors. In this last case, the FDIC insures the risk that otherwise would be borne by the depositor, and therefore is really in the final loss position.

   This FDIC-insured risk is the only banking risk formally underwritten by the U. S. government. Therefore in the absence of any systemic risk, this should be the only risk of concern to the bank regulators, who therefore can be properly viewed as underwriters and risk mitigation specialists for the FDIC. As an insurer the FDIC should follow certain well-established insurance principles. First among these is diversification of and non-correlation of the risks that it insures, followed closely by discouragement of adverse selection of insured risks.

   The concentration of insured risks in a few large depository institution holding companies in itself violates the first of these principles. The largest FDIC-insured depository institution (Bank of America), for example, has about 10% of all insured deposits in the country. We believe that the ten Basel II-mandatory banks hold nearly half of all insured deposits. The fact that credit risks within each of these institutions may be diversified mitigates but does not eliminate the concentration of risk that each of these institutions, as an insurable risk, poses to the FDIC. The fact that one loss event to the FDIC from one of these institutions likely would mean other large loss events—what is known as "systemic risk"—means that in addition to being undiversified (viewed from the FDIC's point of view as an insurer), risks among large institutions are likely to be highly correlated.

On the other hand, the remaining roughly 7,500 banks hold the remaining roughly half of all FDIC-insured deposits; the largest among them probably holds only slightly more than 1%. While risk within each of these banks may be more concentrated, viewed from the position of the FDIC-as-insurer this may represent a reasonably diversified risk pool. Because the failure of any one of these banks would likely have little impact on most if not all of the others, it also may be a more uncorrelated pool of risks.

Therefore, the bank regulatory agencies should adopt capital standards that recognize that (1) large banks represent greater inherent risk to the FDIC due to the fact that each represents a concentration of risk and due to the correlation of risk among them, and (2) smaller banks represent less inherent risk to the FDIC due to the fact that they are a large, diversified, largely uncorrelated risk pool. Regulators are right therefore to demand that large institutions have far more sophisticated risk measurement and management practices than smaller banks. In Enterprise Risk Management terminology, this recognizes the difference between inherent risk and residual risk after mitigation. Since the "loss given default" of one of these institutions would be quite high, it is prudent to insist that their "probability of default" be reduced to a minimum through a combination of risk systems and risk capital. For smaller banks, however, since "loss given default" to the FDIC is relatively small and less likely to trigger other defaults (bank failures), a higher level of "probability of default" can be tolerated. This leads rationally to a need for less sophisticated risk systems, and even potentially lower, not higher, regulatory capital requirements. It is not inconsistent with this line of reasoning for regulators to demand that risk systems and economic capital for large banks be designed to achieve, say, a AA+ or even AAA default probability, while requiring only perhaps an "A" default probability for smaller banks.

We go through reasoning this to point out that from a regulatory and FDIC-as-insurer perspective, there is less need to pressure non-mandatory Basel II banks to upgrade their risk management practices toward Basel II-like levels (as is happening through examination pressure). Similarly, there is no regulatory reason to require that non-Basel II banks have higher capital levels than the largest banks. Yet, for the most part, Basel II, examination practices and this ANPR would continue to lead to just these results.

At the same time, in practice, rating agencies, applying a different perspective, will likely continue to hold regional banking companies that issue rated debt to a higher capital standard than large banks regardless of what regulators do. The constituencies of the rating agencies are the debt holders of each issuing institution. Unlike the FDIC, which insures a risk pool of all banks, debt holders are holding exposure to risk that is institution-specific. Therefore, they may rationally view a smaller banking company issuing rated debt as representing a less diversified, higher default probability risk than a larger company. At the same time the "too big to fail" doctrine (or perception) may well mean that, from the vantage point of rating agencies/debt holders, both PD and LGD are likely to be lower in a big institution. Therefore, it is likely that regardless of what regulators do with risk-based capital, rating agencies are likely to continue to require that smaller issuing banks hold more capital than large banks to get the same rating, all else being equal. Thus, any regulatory scheme involving insured deposits, coupled with rating agency views, will likely drive the industry in the direction of greater concentration, which paradoxically increases risk to the deposit insurer—the FDIC.

In attempting to address the competitive equity questions that may arise under Basel II, the best that the regulatory agencies can do is to assure that they do not exacerbate the competitive inequities that almost certainly will be perpetuated by the rating agencies. Those inequities exist in the current Basle I environment. Under Basel II, and the kind of Basel Ia suggested by the ANPR, these inequities only will grow, especially if the leverage constraint is relaxed for the large Basle-II mandatory banks.

2. The ANPR does almost nothing to address these issues. It proposes to create new risk weighting categories, which may be helpful, but this cannot be known unless the specifics of what loan types, of what quality, measured how, are spelled out. The proposal with regard to risk weightings of single-family mortgages is directionally correct, but it appears based on limited data included in FDIC testimony on QIS 4 that it will still leave Basel Ia banks at a meaningful capital disadvantage for this type of lending. The same comments could be made about the possible reduction in risk weighting for some small business loans.

   The ANPR's proposals with regard to the risk weighting of both (a) loans to borrowers with agency rated debt or (b) guarantees by rated borrowers are of almost no relevance. Community banks rarely lend to companies with rated debt. Most regional banks have very limited exposure to these types of borrowers. Zions Bancorporation, for example, prior to its recent acquisition of Amegy Bancorporation had credit exposure to fewer than fifty borrowers with rated debt, and total exposure to them of only a few hundred million dollars out of approximately $24 billion of total loans (we have not quantified this post-acquisition). There are two simple reasons for this:

   - Companies with rated debt, particularly investment grade rate debt, have access to alternatives to bank lending at lower spreads;

   - Companies with rated debt usually are larger, and have borrowing needs of a size that a community/regional bank cannot meet without incurring an undue concentration risk.

So, there is no way to improve the ANPR proposal with regard to lower capital for rated debt or guarantees; it is simply largely irrelevant. In fact, the ANPR proposal is quite strange in one respect: it proposes to drastically *increase* the risk weightings applied to rated credits that are below investment grade. The fact is that a large portion of the on-balance-sheet credits of community and regional banks, and probably even large banks, have "pass" loan grades that would be below investment grade, calibrated to the PD's and LGD's of agency ratings. Intermediating these credits is a core business of banking today. By suggesting that risk weightings of below investment grade rated debt need to be drastically raised, to be logically consistent the regulatory agencies should also be saying that the capital required for much on-balance-sheet lending to unrated companies should be drastically raised. Yet it is not clear that the QIS 4 data support this.

The ANPR also potentially would increase the risk weightings to the CRE lending that also is a "bread-and-butter" business of regional banks. It does so despite the fact that QIS 4 results seemed to indicate a reduction of economic capital in these categories by banks participating in the study. Neither the ANPR nor the recently released (January 11) proposed Guidelines on Commercial Real Estate Lending (which propose significantly tightened risk management processes and hint at higher capital requirements for these activities) offer any quantitative explanation or justification. Loan losses in SME and particularly CRE lending have been markedly lower for the last fifteen years than previously. Bank loan losses and problem credits in the most recent real estate downturn were markedly lower than in the circa 1990 downturn. Both PD and LGD were lower in the recent downturn, we believe, due to major improvements in CRE underwriting (see "5" below). This is why QIS 4, rigorously based on sophisticated, quantitative Basel II risk management systems using loss data from recent experience, resulted in lower economic capital requirements for CRE lending. At the same time, the regulatory agencies, reflecting non-quantitative, ill-defined concerns appear to be pushing for possible higher capital for CRE lending by Basel 1a banks. At Zions we cannot follow the logic. It seems to be nothing other than credit allocation reflecting the current biases of the regulatory agencies.

3. Even if the regulators "got it exactly right" with the final rule and established risk weights that perfectly captured the risk of today's underwriting and risk management practices and economic conditions, changes to either or both could quickly make them obsolete and incorrect. Basel II capital requirements, by definition, will be updated continuously as new default, exposure, and loss given default data are incorporated into the quantitative analysis. In times of low losses, the capital required by Basel II banks will drift lower, while capital required under Basle I or Ia will not. Thus in good times large banks will operate at an increasing competitive advantage in various types of lending compared to community and regional banks, and will squeeze them out of the market or into lower quality credits. It is not clear why this is a logical or desirable outcome; nor is its converse when conditions deteriorate.

Given the inevitable controversy that would attend any attempt to modify Basel Ia risk weights and the inherently time-consuming nature of the regulatory rule-making process, there is no way to adjust timely Basel Ia requirements in response to changing conditions. Thus, illogical results and competitive inequities are inevitable consequences of the Basel Ia approach of fixed weights specified in regulation.

4. We suggest a very different approach to a Basle Ia framework in order to overcome these very material problems with the ANPR: link capital standards in Basel Ia by loan category to the average capital levels of the Basel II banks. While there is no theoretical reason to do so (see #1 above), to make it politically saleable, this could be done with a slight "penalty" to compensate for the substantial cost to the Basel II banks of adhering to that standard. For example, if the average economic capital level calculated by Basel II banks for unsecured SME loans of good quality was 5.0%, adding for example a 2% premium to that would result in a 5.10% capital requirement by well-managed Basle Ia banks for that type of loan. If over time Basel II banks' calculated economic capital rose to 6.0% for these loans, the requirement for Basel Ia banks would increase to 6.12%. This type of standard could be administered by regulatory agencies conducting a type of QIS every couple of years, and then publishing the results for a defined number of loan categories.

   If this approach were adopted, we would support the abolition of the Leverage Ratio constraint. Community and regional banks could then compete without a material capital disadvantage vis-à-vis Basle II banks on any single or combination of lines of business.

   However, if something like this proposal is not adopted, we believe that regulators should retain in perpetuity the same Leverage Ratio standard for all banks, at or close to its present level. The widely varying results from the QIS4 study (larger differences across institutions, and variances across products) suggest that constant leverage ratio is needed to mitigate the imprecision inherent in the complex internal risk based (IRB) systems used by the largest banks. In conjunction with Basel II this would have the effect of requiring much greater risk management sophistication on the part of large banks without giving them an overall capital advantage vis-à-vis other banks. In this scenario, if Basel II banks lower their pricing in response to lower economic capital for higher quality credits, some banks might still be able to match their pricing and earn adequate returns on equity--if they managed their portfolio to include a variety of businesses of varying risk characteristics. In other words, smaller banks could "price match" the Basel II banks, and manage their portfolio mix to achieve an adequate return on the capital required by the leverage ratio. *However, it should be noted that it will be far more difficult for regional banks to manage such a portfolio than for very large banks, and nearly impossible for community banks.*

5. If the regulators are unwilling to seriously explore this proposal, the only way to improve the ANPR from the perspective of most community and regional banks will be to give recognition to the most common risk mitigation techniques actually used by these banks in their core SME and CRE lending: personal guarantees, cross-collateralization, and loan-to-value ratios.

   A core business of community banks is lending to privately held and closely held businesses that do not have rated public debt, for reasons previously discussed. It is very common in such lending to obtain personal guarantees from business owners and/or obtain collateral in the form of other assets owned by the principals in the business. These measures lower both PD (because the principals cannot simply walk away from the failing business) and LGD (because of the recovery potential from other sources). Current regulatory examination practice gives little weight to these measures, and the ANPR continues to ignore these important tools. Regulators should instead be encouraging such risk mitigation practices, for example by requiring less capital where they are used and enforced.

   Similarly, risk mitigation measures adopted by the industry, we believe, significantly explain why CRE PD's and LGD's in the most recent downturn led to very low loan losses, compared to substantial losses in the circa 1990 downturn. The regulatory agencies seem unwilling to recognize in theory or in practice the importance of these risk mitigants. A Moody's study of the circa 1990 commercial real estate collapse (published in May 2002) estimated that the actual default rate on CRE lending then was approximately 16%, triggered by peak-to-trough property value declines approaching 40% and starting loan-to-value ratios averaging perhaps 80%. When vacancy rates increased and property values began to decline, the 20% equity was wiped out relatively early in the downturn. As distressed and defaulted properties piled into the market, this exacerbated the decline in values. More properties defaulted (PD's increased) and loss given default (LGD) also increased in a vicious cycle.

   In the circa 2000 period, vacancy rates in a number of commercial markets approached those of the 1990 era, however, the much anticipated pile-up of loan losses and defaulted properties at banks never materialized. Why not? Because LTV's going into this decline were much lower, i.e., CRE deals on average had much greater equity under the loan. It took a much greater decline in value to wipe out this equity, and equity holders had an incentive to "hang on"—coming out of pocket to support negative cash flows in many cases. PD's were much lower, leading to a much smaller overhang of defaulted properties, which did not put as much pressure on values. Defaulted properties were quickly sold in the absence of overhang, and LGD's were minimized in a *virtuous* circle.

Capital policies should recognize the value of such risk mitigants as low LTV's in CRE lending, and provide incentive to use them. Basel II does so by incorporating into the evolving economic capital calculations the low PD and LGD data of the last ten years. However, although Zions has had *net recoveries* in aggregate over the last five years from CRE lending for the same reasons, it will get no benefit from that fact under Basel Ia. In fact banks such as Zions are threatened with *higher* capital requirements for much of its CRE lending under Basel 1a and under the proposed new CRE lending guidelines, despite this exemplary track record.

In effect the regulatory agencies are now telling Basel II banks to develop and rely on data intensive quantitative models for management of credit risk, but imposing standards on non-Basel II banks based on the agencies' qualitative judgments that are not supported by empirical data. If proposal "4" above was adopted, the agencies could escape this trap. It is not clear that they can do so under the ANPR Basel 1a framework.

<u>Conclusion</u>

Zions sincerely appreciates the agencies' recognition of the inequities inherent between Basel II and Basle I. However, for reasons articulated above, we believe that no version of Basel Ia can overcome its problems. Giving credit for the common risk mitigation measures taken in the core lending activities of regional and community banks would help, but we recognize that it is difficult, although perhaps not impossible, to come up with a regulation that would incorporate guarantees, LTV's and cross-collateralization measures in risk weightings for commercial types of lending. We therefore strongly encourage consideration of the approach described above.

Very truly yours,

Doyle L. Arnold
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