March 25, 2007

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

Regarding: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Domestic Capital Modifications

Dear Mr. Feldmann:

Thank you for this opportunity to comment on the Notice of Proposed Rulemaking ("NPR") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision (together, the "Agencies") regarding proposed revisions to the Agencies' existing domestic risk-based capital rules.

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

It is my professional opinion that regulatory capital requirements should be more closely aligned with risk to enhance the safety and soundness of the banking system. Exposures that have higher risk should require more capital; and, conversely, lower risk exposures should require less capital. A one-size-fits all capital charge of 8 percent for all risk exposures (4 percent for mortgages) is not a truly risk sensitive capital standard. In an appropriately risk sensitive capital regime, capital will either be higher, or lower, relative to risk.

The two NPR proposals that the agencies have submitted for industry comment with regard to revising risk-based capital standards both contain requirements that are not appropriately risk sensitive. Both appear to require more capital than the existing Accord in certain instances, and certainly a higher capital level than the 2004 International Framework. My colleagues at the bank and I believe that the best way forward at this point is the full adoption and implementation of the 2004 International Framework. We would urge the agencies to abandon the so-called Basel 1A

proposal, and, instead, offer the availability of all three approaches contained in the 2004 International Framework: 1) Standardized, 2) Foundation IRB, and 3) Advanced IRB. We do not believe that the proposed regulatory capital regime as outlined in the NPR, the Basel 1A proposal, is sufficiently risk sensitive nor do we believe that it would necessarily enhance the safety and soundness of the banking system. In some instances it calls for an increase in current capital requirements that could be unnecessarily punitive. As proposed, it would also increase regulatory burden when compared to the Standardized Option in the 2004 International Framework.

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

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

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

Moreover, when the Framework was released in 2004, the Basel Committee stated that, “this evolution is necessary to ensure that the Framework keeps pace with market developments and advances in risk management practices, and the Committee intends to monitor these developments and to make revisions when necessary.” We are very concerned that the U.S.’s continued divergence from the 2004 Framework could prevent further innovation in industry risk management practices.

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

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

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

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

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

Under the Foundation approach, banks provide their own estimates of PD associated with each of their borrower grades, but generally use supervisory estimates for the other relevant risk components, *i.e.*, LGD, EAD and M. Pursuant to Basel II, a bank must demonstrate to the satisfaction of its supervisor that it meets certain minimum requirements at the outset and on an ongoing basis in order to be eligible to use the Foundation approach. Many of these requirements are in the form of objectives that a qualifying bank's risk rating systems must fulfill. The focus is on banks' abilities to rank order and quantify risk in a consistent, reliable and valid fashion.

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

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

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

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

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

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

Sincerely,

Graham B. Painter
Executive Vice President
Sterling Bank, Houston, TX