INDEPENDENT COMMUNITY BANKERS of AMERICA

March 26, 2007

Office of the Comptroller of the Currency
250 E Street, SW
Mailstop 1-5
Washington, DC 20219
November 9, 2005

Attention: Docket 06-15

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Comments/Legal ESS

Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
20th Street an Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1238

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: No. 2006-49

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

Dear Sir or Madam:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to offer comments on the Notice of Public Rulemaking (Basel IA NPR) issued by the banking agencies and published in the *Federal Register* on

[1] [1]*The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

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December 26, 2006 regarding proposed revisions to the current U.S. risk-based capital rules for banking organizations known as the Basel I capital rules. The NPR proposes various changes to the Basel I capital rules including increasing the number of risk-weight categories, permitting greater use of external ratings as an indicator of credit risk for externally-rated exposures, expanding the range of recognized collateral and eligible guarantors, and using loan-to-value ratios to risk weight most residential mortgages.

Summary of ICBA's Position

ICBA strongly supports creation of the Basel IA capital rules. ICBA has long advocated revising Basel I to make it more risk sensitive and to address any competitive issues with using a bifurcated capital system. The non-Basel II banks need a more risk-sensitive capital accord in order to be able to compete effectively with the Basel II banks. **ICBA particularly commends the agencies for their proposal to allow the non-Basel II banks to opt-in to Basel IA.** Many community banks have excess capital and would prefer to remain under Basel I or the existing risk-based capital framework without revision.

ICBA has a number of recommendations for improving the Basel IA proposal including:

Total Risk Weight Categories. ICBA supports adding three more risk categories—10, 35, and 75 percent---to the current five risk categories (e.g., 0, 20, 50, 100 and 200 percent) that are already in the Basel I rules. ICBA believes that adding more than three risk weight categories to the current five risk categories would complicate the task of computing risk-based capital for a community bank or holding company. We believe our additional risk weight categories will closer align Basel IA with Basel II than the three additional risk weight categories proposed by the agencies.

1-4 Family Mortgages. ICBA strongly endorses the agencies' proposal in the Basel IA NPR to add additional risk weight categories (e.g., 35 and 75 percent) for assessing a bank's one-to-four family mortgage portfolio and to base those risk weights on loan-to-value ratios. We also recommend adding an additional 10% category to reflect the low risk involved with first lien mortgages with low LTV ratios and to address the difference in treatment of mortgages between Basel II and Basel IA**.**

While using credit scores in conjunction with LTV ratios might further enhance the risk sensitivity of the mortgage loan risk weights, it would substantially complicate the process of computing risk-based capital. For many community banks, the regulatory burden of including credit scores would outweigh the benefit.

Stand-alone Junior Mortgages. For stand-alone junior mortgages, we also agree with the agencies that a banking organization should use the

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combined LTV of that loan and all senior loans to determine the appropriate risk weight for the junior lien. However, we recommend changing the proposed risk weight designations in Table 5 for stand-alone junior mortgages by substituting a risk weight of 50% for the 75% risk weight category, 75% for the 100% category, and capping the highest risk weight category for these loans at 100% instead of at 150%.

Small Business, CRE and Multi-Family Residential Loans. As for small business loans, we recommend that the agencies establish a 75% risk weight category for small business loans that are under $2 million and that are (1) fully collateralized (2) amortizable over a period of 10 years or less, and (3) have been originated consistent with the banking organization's underwriting policies.

For small business loans secured by real estate with low LTV ratios and for commercial real estate (CRE) and multi-family residential loans with low LTV ratios, ICBA favors lower risk weight categories regardless of the size of the loans. For instance, for small business, CRE and multi-family residential loans with LTVs of 80% or less, we recommend a 75% risk weight and for small business, CRE, and multi-family residential loans with LTVs of 60% or less, we recommend a risk weight of 50%.

External Credit Ratings and GSE Exposures. ICBA also agrees with the concept of using external credit ratings to enhance the risk-sensitivity of the Basel I risk-based capital rules and supports the use of the proposed risk weight categories for categorizing rated investment securities as illustrated in Tables 1 and 2 of the Basel I NPR. However, ICBA believes that the current 0% risk weight for short- and long-term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government should be retained as well as the 20% risk weight for U.S. government-sponsored entities and for general obligation municipal securities. The agencies should not consider the idea of risk weighting GSE exposures based on independent financial strength (IFS) assessments.

Core Deposit Intangibles. In keeping with the stated policy objectives of Basel IA, we believe that the recognition of the risk-mitigating benefits of contractual arrangements furnished by investment grade-rated third parties to cover risk exposures should be extended to core deposit intangible assets and that these assets should be included as part of a bank's regulatory capital.

Basel II and the Standardized Approach. To reduce the costs and complexity of Basel II, to enhance its flexibility, and mitigate the competitive disparities between Basel II and Basel I banks, ICBA supports allowing Basel II banks the option of using the "standardized approach" of the Basel II framework in lieu of the advanced IRB approach. ICBA believes that the use of the standardized approach by Basel II banks would reduce the impact on risk-based

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capital by those banks and would mitigate to some extent, the competitive disparity between Basel I and Basel II.

Capital Safeguards. ICBA strongly supports the decision by the agencies to maintain the capital-to-assets leverage ratio requirement for all banks, including the Basel II banks, and the establishment of individual floors and a 10% system-wide trip wire during the Basel II transitional period to prevent significant decreases in minimum risk-based capital. During 2008—the year of the parallel run--ICBA recommends that the agencies conduct another study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. If the new competitive impact study indicates a continuing competitive disparity between Basel II and Basel IA, then the three-year transition period should be put on hold until the regulators fundamentally revise Basel II. If Basel II cannot be revised to eliminate the competitive disparity, then the agencies should require that all banks either use Basel IA or Basel I.

Background of the Basel I Proposed Revisions

Adopted in 1989, the current U.S. risk-based capitals rules are based on the "International Convergence of Capital Measurement and Capital Standards" which is known as Basel I. Under the Basel I framework, banking organizations are required to assign balance sheet exposures to one of five categories of credit risk, which carry minimum capital charges ranging from zero to eight percent. Almost all exposures to individuals and companies, other than residential mortgages, are assigned to the standard risk weight category (i.e., the 100 percent risk weight category), limiting the extent to which the Basel I rules recognize risk differentials among different credit exposures.

In response to concerns that Basel I was not sufficiently a broad indicator of risk for many exposures held by the large banking institutions, the Basel Committee on Bank Supervision launched an effort to fundamentally revise Basel I. These efforts culminated in the Committee's release in June 2004 of a revised capital framework known as Basel II. On August 2003, the banking agencies issued an advance notice of proposed rulemaking for the implementation of Basel II in the United States which indicated that Basel II would only apply only to the ten to twelve largest U.S. banking organizations that have total assets of $250 billion or more or total on-balance sheet foreign exposure of $10 billion or more. Other institutions would have the opportunity to opt-in to Basel II provided they meet very strict eligibility standards. ICBA commented on the Basel II ANPR and expressed our concerns about the complexity of Basel II and the competitive inequities that would result if Basel II were implemented. ICBA also recommended further changes to Basel I to make that accord more risk-sensitive and address the competitive inequities presented by Basel II.

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To assist in quantifying the potential effects of Basel II, the Agencies conducted a quantitative impact study during late 2004 and early 2005 (QIS 4). QIS 4 was a comprehensive effort completed by 26 of the largest banking organizations using their own internal estimates of the key risk parameters driving the capital requirements under the Basel II framework. The results of the study indicated that the aggregate minimum risk-based capital requirements for the 26 banking organizations would drop approximately 15.5% relative to the existing Basel I-based framework.

On October 20, 2005, the agencies issued an advanced notice of proposed rulemaking soliciting public comment on possible revisions to U.S. risk-based capital rules that would apply to non-Basel II banking organizations (Basel IA ANPR). ICBA generally supported the Basel IA proposal with some recommended changes provided that community banks would have the option to continue using the existing risk-based capital rules. ICBA has long advocated revising Basel I to make it more risk sensitive and to address any competitive issues with using a bifurcated capital system. ICBA also supported the Basel IA ANPR's proposal to add more risk categories to the Basel I rules to enhance their risk-sensitivity and to align capital requirements with risk levels.

In testimony before the House Financial Services Subcommittee on September 14, 2006[2] and in a written statement to the Senate Banking Committee on September 26, 2006[3], ICBA commended the banking agencies for their decision to retain the tier 1 leverage ratio as part of the Basel II Notice of Proposed Rulemaking.[4] ICBA strongly believes that retention of the leverage ratio is essential to maintaining the safety and soundness of our banking system and is a needed complement to the risk-sensitive Basel II framework that is based only on internal bank inputs. ICBA also commended the banking agencies for adopting "floors" during the transitional period that would limit the reduction of minimum risk-based capital for the Basel II banks to 5%. We agreed with the agencies that if there is a ten percent or greater decline in aggregate minimum risk-based capital during the transition period, then there should be a fundamental revision of Basel II.

Despite the safeguards incorporated into Basel II mentioned above and the efforts by the regulators to revise Basel I, ICBA told the House and Senate Committees that we remained concerned that Basel II may place community banks at a competitive disadvantage. The IRB approach of Basel II will yield lower capital charges for residential mortgage, retail and small business loans for Basel II adopters, the very credits where community banks compete with large institutions. For instance, QIS4 indicated that for the Basel II

[2] See testimony of James H. McKillop before the House Subcommittee on Financial Institutions and Consumer Credit dated September 14, 2006.
[3] See ICBA's Statement before the Senate Banking Committee dated September 26, 2006 entitled "Basel Capital Accord Update."
[4] See Notice of Proposed Rulemaking on Basel II published in the Federal Register on September 25, 2006 at 71 FR 55380.

banks, there would be a 79% median percentage drop in minimum required capital for home equity loans, a 73% drop for residential mortgage loans, and a 27% drop for small business loans. Since there is a cost to a bank for maintaining capital, the lower capital requirements would most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II.

ICBA also fears that Basel II will further accelerate the consolidation in the banking industry. Lower capital levels that large banks obtain under Basel II will likely result in more acquisitions of community banks by the larger banks seeking to lever capital efficiencies. As more of the larger banks opt-in to Basel II over the long-term, this may eventually threaten the viability of community banking.

The agencies are now proposing changes to Basel I that are similar to the Basel IA ANPR but that incorporate a number of recommendations made by ICBA and other commenters.

ICBA's Specific Comments Regarding the Basel IA NPR

Opt-In/Opt-Out Proposal

ICBA commends the agencies for proposing to allow non-Basel II banks to opt-in to Basel IA. As we stated in our comment letter concerning the Basel IA ANPR, many community banks have excess capital and would prefer to remain under Basel I without revision to avoid unnecessary burden. This is particularly true for smaller banks that are management-owned, otherwise closely held, or not publicly traded, or banks in rural or other smaller markets. These banks generally hold higher amounts of capital than regulatory minimums for a variety of reasons including a conservative philosophy or lack of ready access to raise capital in the capital markets.

For instance, the average total risk-based capital ratio for banks under $100 in assets is 27.30% and for banks between $100 million and $1 billion, the ratio is15-16%.[5] For these banks, computing risk-based capital minimums and ratios using the contemplated Basel IA could present a significant regulatory burden with no corresponding benefit. These community banks will likely choose not to opt-in to Basel IA.

ICBA favors allowing banks the flexibility to opt-out of Basel IA after opting in, provided the bank has first notified its primary Federal supervisor. We believe that an appropriate notice period would be 30 days prior to the change. In its review of such a request, the primary Federal supervisor would ensure that the risk-based capital requirements appropriately reflect the risk profile of the banking organization and the change is not for purposes of

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[5] See FDIC News Release and Chart 3 of the Memorandum from Christopher J. Spoth to the FDIC Board dated October 6, 2005.

capital arbitrage. ICBA recognizes that the agencies would retain the authority to require a non-Basel II banking organization to use either the existing or the proposed risk-based capital rules if the banking organization's primary Federal supervisor determines that a particular capital rule is more appropriate for the risk profile of the banking organization.

Increasing the Total Number of Risk-Weight Categories

As we also stated in our comment letter concerning the Basel IA ANPR, ICBA favors adding additional risk-weight categories to the Basel I risk-based capital rules to enhance their risk-sensitivity and to align capital requirements with risk levels. However, the revisions should not be so complicated that computing risk-based capital becomes a regulatory burden for banks. As one of our member bank officers put it, "we don't want the risk-based capital rules to become the regulatory burden that the Call Report has become**." ICBA therefore recommends that three additional risk-weight categories—10, 35, and 75 percent—should be added to the five categories that are already in existence—zero, 20, 50, 100, and 200 percent.** Additional weight categories over these eight categories would complicate the task of computing risk-based capital for a community bank or holding company.

One-to-Four Family First Mortgages

Under the existing risk-based capital rules, most one-to-four family first lien mortgages are generally eligible for a 50% risk weight. ICBA believes that this "one size fits all" approach to risk-based capital does not accurately assess suitable levels of capital for either low- or high-risk mortgage loans. **Therefore, ICBA strongly endorses the agencies proposal in the Basel IA NPR to add additional risk weights (e.g., 35 and 75%) for assessing a bank's one-to-four family mortgage portfolio and to base those risk weights on loan-to-value ratios or LTV ratios. We recommend also adding an additional 10% category to reflect the very low risk involved with mortgages with low LTV ratios.**

We also generally agree that Table 3 of the Basel IA NPR is an appropriate way to categorize residential mortgages based on LTV ratios. However, we suggest several changes to the table to reflect the overall low risk involved with mortgage loans. **First, we recommend establishing a 10% risk weight category for those very low risk mortgages with loan-to-value ratios of less than 30%. We suggest also extending the 50% category so that it would cover mortgages with LTVs greater than 80% but less than 90% and extending the 75% category to cover mortgages with LTVs greater than 90% but less than 100%. For all mortgages with LTV ratios greater than 100%, the risk-weight category should be no higher than 100%.**

If ICBA's recommendations were adopted, Table 3 would look as follows:

Proposed LTV and Risk Weights for 1-4 Family First Liens

Loan-to-Value ratios (%)	Risk weight (%)
30 or less………………………………………………...	10
Greater than 30 and less than or equal to 60………..	20
Greater than 60 and less than or equal to 80………..	35
Greater than 80 and less than or equal to 90………..	50
Greater than 90 and less than or equal to 100………	75
Greater than 100………………………………………..	100

ICBA believes that risk-weighting a residential loan at 100% with an LTV of between 91-95% as proposed by the agencies or risk-weighting a loan at 150% with an LTV higher than 95% is too high a risk assessment. Residential loans with LTV ratios of between 91-100% are often made by community banks in rural areas where property values are low. These residential mortgage loans seldom result in any measurable loss to the bank and therefore should carry a lower than 100% risk weight.

Furthermore, if one of the goals of Basel IA is to "minimize differences in capital requirements that may give risk to competitive imbalances between large and small banks" ICBA believes that the risk weight categories for mortgages for the non-Basel II banks needs to be adjusted downward from those proposed in the Basel IA NPR to account for the disparity in treatment that will result between the two accords.[6] In order to compete with Basel II banks for mortgages, the risk-weights for the non-Basel II banks need to be reduced by an amount significantly less than the 50% requirement now imposed by Basel I for mortgages. The agencies proposal to risk weight mortgages with LTVs of between 91-95% at 100% and to risk weight mortgages with LTVs over 95% at 150% is inconsistent with the goal of achieving closer parity with the Basel II banks.

We agree with the agencies as to how LTVs are to be calculated. The value of the property should be based on the value at origination and banks should have the flexibility to update the values for risk-weight purposes when the borrower refinances the mortgage and extends additional funds. For mortgages that are positively amortizing, banks should also have the flexibility to adjust the LTV quarterly to reflect any decrease in the principal balance. For mortgages that negatively amortize, banks should be required to adjust the LTV quarterly to

[6] According to an FDIC study that is based on QIS4 data, under Basel II, median risk weights for 1-4 family mortgages would be 16% whereas under Basel IA, median risk weights for 1-4 family mortgages would be at 35%, resulting in a significant capital advantage for the Basel II banks for these loans. See chart prepared by the FDIC staff on page 11 of the FDIC Basel IA release..

reflect the increase in principal balance and risk weight the loan based on the updated LTV.

As noted in our comment letter on the Basel IA NPR, while using credit scores in conjunction with LTV ratios might further enhance the risk sensitivity of the mortgage loan risk weights, it would substantially complicate the process of computing risk-based capital. Besides the fact that some banking organizations do not rely heavily on credit scoring, those that use credit scores would have to develop operational methods and software for inputting and tracking the scores and categorizing the loans. Credit scores are also much more volatile than LTV ratios and can be inaccurate; therefore, banking organizations would need to periodically update the scores, check their accuracy and possibly change the risk weight category of a loan. For many community banks, the regulatory burden of including credit scores with LTV ratios would outweigh the benefits.

Junior Mortgages

ICBA agrees that if a banking institution holds both a first and second lien, including a home equity line of credit (HELOC), then the two loans should be combined to determine the appropriate LTV ratio and thus risk weight for both loans. This is consistent with the way junior mortgages are risk weighted under the existing Basel I rules. We agree that Table 3 as described above (e.g. "Table for LTVs and Risk Weights for 1-4 Family First Liens") after incorporating the recommendations we made, could be used to determine the risk weights where the banking institution holds both the first and second lien.

For stand-alone junior mortgages, we also agree with the agencies that a banking organization should use the combined LTV of that loan and all senior loans to determine the appropriate risk weight for the junior lien. However, we disagree with the proposed risk weight designations in proposed Table 5 for these stand-alone junior mortgages**. In our opinion, the proposed risk weights for stand-alone junior mortgages should be significantly reduced to accurately reflect the credit risk of these types of loans. We recommend substituting 50% for the 75% risk weight category, 75% for the 100% category, and capping the highest risk weight category for these loans at 100% instead of at 150%.** As revised, Table 5 would be as follows:

Table 5.---Proposed LTV and Risk Weights for 1-4 Family Junior Liens

Combined loan-to-value ratios (%)	Risk Weight (%)
60 or less…………………………	50
Greater than 60 and less than or equal to 90	75
Greater than 90…………………………….	100

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We believe that proposed Table 5 more accurately reflects the credit risks associated with stand-alone junior mortgages. For instance, the proposal to risk weight stand-alone mortgages at 150% with LTVs higher than 90% assumes that the credit risk for these types of loans is significant, when in reality, these loans do not justify capital greater than 100% of the amount of the loan if they are prudently underwritten. Furthermore, if the goal of Basel IA is "to minimize differences in capital requirements between the two accords," ICBA believes that the risk weight categories for stand-alone junior mortgages for the non-Basel II banks also needs to be adjusted downward from those proposed in the Basel IA NPR to compensate for the large disparity in treatment that would result between Basel II and Basel IA.[7] The non-Basel II banks need lower risk categories for the stand-alone junior mortgages to compete with the Basel II banks for these loans.

Transitional Rule for Mortgages

ICBA strongly agrees with the proposal in the Basel IA NPR that banks that choose to apply the Basel IA rules be allowed to continue risk weighting existing mortgage loans using the existing risk-based capital rules. For some community banks, this would reduce the cost and burden associated with recoding existing loans to conform to a new system. Only new mortgage loans would then have to be coded to apply the new risk-based rules. We believe that such a transitional rule will minimize the burden associated with using Basel IA and encourage more community banks to opt-in to Basel IA.

Certain Small Business Loans

Under the existing risk-based capital rules, a small business loan is generally assigned to the 100 percent risk-weight category unless the credit risk is mitigated by an acceptable guarantee or collateral. Although no specific proposal was made in the Basel IA NPR, the agencies are considering a lower risk weight (e.g., 75%) for certain small business loans that are (1) $1 million or less, (2) personally guaranteed by the owner or owners of the business and are fully collateralized, (3) amortizable over a period of nor more than seven years, and (4) prudently underwritten and performing.

ICBA strongly supports a lower risk weight category for certain small business loans under Basel IA. However, to accommodate banks in urban areas that have experienced high real estate appreciation, we recommend raising the $1 million threshold. Many community banks in urban areas are now routinely making small business loans in excess of $1 million**. ICBA recommends that the agencies establish a 75 percent risk weight category for small business loans that are under $2 million and that are (1) fully collateralized and personally guaranteed by the owner or owners of the business (2) amortizable over a period of 10 years or less, and (3) have**

[7] The FDIC chart referenced in footnote 6 above also indicates that median risk weights under Basel II for typical home equity loans would be 19% whereas under Basel IA, median risk weights for home equity loans would be 100%, resulting in another large capital advantage for the Basel II banks.

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been originated consistent with the banking organization's underwriting policies. This lower risk category would compensate to some extent for the capital advantage that the Basel II banks have with regard to small business loans.[8]

ICBA also favors lower risk categories based on LTV ratios for small business loans regardless of size if they are fully collateralized by real estate. For instance, for small business loans with LTV ratios of 80% or less, we recommend a 75% risk weight and for small business loans with LTV ratios of 60% or less, we recommend a risk weight of 50%. These lower risk categories would help Basel IA banks compete with the Basel II banks and minimize the capital differences between the two accords.

Loans 90 Days or More Past Due

ICBA commends the agencies for dropping the proposal to assign loans that are 90 days or more past due (or that are in non-accrual status) to a higher than 100 percent risk weight category. We believe that the more appropriate way to deal with the risk involved in these kinds of loans is by providing adequate reserve amounts through the bank's loan loss reserve account. As long as they are adequately reserved for, loans that are 90 days or more past due should only be categorized in one risk weight category. If they are not adequately reserved for, than the banking institution should be increasing its loan loss reserves (or face the penalty of having inadequate loan loss reserves) and not be concerned about changing its risk based capital.

Commercial Real Estate and Multi-Family Residential Exposures

In our comment letter on the Basel IA ANPR, we recommended that the agencies conduct a study to determine appropriate risk weights for commercial real estate (CRE) exposures. We still believe that the agencies should develop a risk-weighting framework for CRE exposures that is not burdensome to community banks and that will protect the safety and soundness of the banking system without impacting the availability of small business credit.

Similar to our proposed treatment of small business loans, ICBA also favors lower risk categories based on LTV ratios for CRE and multi-family residential exposures regardless of their size. For instance, for CRE and multi-family residential loans with LTV ratios of 80% or less, we recommend a 75% risk weight and for CRE and multi-family residential loans with LTV ratios of 60% or less, we recommend a risk weight of 50%.

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[8] The FDIC study reference in footnotes 6 and 7 indicates that median risk weights for the Basel II banks for small business (retail) loans would 61% whereas under Basel IA, it would be 100%.

Use of External Credit Ratings

As noted in our comment letter concerning the Basel IA ANPR, **ICBA generally agrees with the concept of using external credit ratings to enhance the risk-sensitivity of the Basel I risk-based capital rules.** Using the external credit ratings that are publicly issued by the Nationally Recognized Statistical Rating Organizations (NRSROs) to assign risk weights for securities held by banks is a reasonable approach to assessing the risk exposure of a bank's securities portfolio. Furthermore, the risk-weight categories in Tables 1 and 2 of the Basel IA NPR are an appropriate way to assess a bank securities portfolio without imposing undue regulatory burden on community banks.

ICBA strongly supports the proposal to keep the current 0% risk weight for short- and long-term U.S. government and agency exposures that are backed by the full faith and credit of the U.S. government and the 20% risk weight for U.S. government-sponsored entities. The current risk-weights for general obligation municipals (e.g., 20%) and for municipal revenue bonds (e.g., 50%) should also be retained. These exposures should not be risk weighted based on external credit ratings and should not be subject to proposed Tables 1 or 2. To the extent that proposed Tables I and 2 apply to "sovereign" exposures, they should only apply to foreign governments and foreign public-sector entities.

The agencies acknowledge that expanding the use of external ratings will have little effect on the risk-based capital requirements for existing loan portfolios at most banking organizations. For a great majority of community banks that invest most of their securities portfolio in either U.S. government and agency securities or municipal securities, neither will using Basel IA external credit ratings to assess the risk exposure of their bank securities portfolio have much impact on their overall risk based capital ratios. However, ICBA believes that as long as the approach is not overly complicated, that over time, community banks will find that a more risk sensitive assessment of their securities portfolio to be beneficial.

Recognized Financial Collateral and Eligible Guarantors

Proposed Basel IA would expand the list of eligible collateral in the existing risk-based capital rules to include (a) securities issued or guaranteed by a sovereign government that are externally rated at least investment grade or an exposure issued or guaranteed by a sovereign government with an issuer rating that is at least investment grade; or (b) securities issued by private entities that are externally rated at least investment grade. It would also expand the list of eligible guarantors recognized for capital purposes to include any public or private entity that has long-term senior debt rated at least investment grade. However, as mentioned above, proposed Basel IA would retain the existing risk-weight of exposures guaranteed by the U.S. government, its agencies, and by GSEs.

Even though few community banks have exposures that are guaranteed by externally rated entities, ICBA supports these proposals as long as the existing risk-weight treatment of exposures guaranteed by the U.S. government and its agencies, the U.S. government-sponsored agencies, and the public sector entities are retained. We agree that the list of eligible guarantors under the existing Basel I risk-based rules are too restrictive and needs to be expanded. We also support expanding the list of recognized collateral to include a broader array of externally rated and readily marketable financial instruments.

Government Sponsored Agencies

In the Basel IA NPR, the agencies indicate that they are considering using financial strength ratings to determine risk weights for exposures to government-sponsored agencies or GSEs, where this type of rating is available. **As noted above, ICBA believes that the current risk weight of 20% for GSE exposures should be retained under Basel IA. ICBA objects to setting the risk weights for GSE exposures based on independent financial strength (IFS) assessments.** There are a number of policy and practical reasons to support our position.

First, the use of IFS ratings is inconsistent with one of the main purposes of Basel IA—to better align capital to the risk of the bank's investment. The IFS is not a measure of risk to banks. Rather it is an attempt to measure the risk to the government that is posed by the GSE's activities. The potential risk to the government is not equivalent to the potential risk to holders of GSE securities, which is reflected in the normal credit ratings assigned by the NRSRO. In short, the risk to the government is not an appropriate basis for assigning risk weights to bank assets.

Second, the market will demand an additional premium to hold GSE securities if risk weights are tied to IFS scores. The additional premium will be required whenever the IFS score translates into a risk weight higher than 20%. However, even if the IFS score does not result in a higher risk weight, the fact that the risk weight may suddenly change in the future creates an uncertainty that will be reflected in the market price. These additional costs will result in higher funding costs for the GSE, which will in turn raise the costs to the consumer of housing finance.

Third, the approach of tying risk weights of GSE securities to IFS scores is inconsistent with the Basel II approach, which uses NRSRO ratings to rate GSE securities. Under the Basel II advanced approach, the risk weight for GSE securities that have a NRSRO rating of highest or second highest investment grade would be considerably lower than the 20% risk weight proposed in the Basel IA NPR. If banks were to tie risk weights to IFS scores, the risk weights for GSE securities under Basel IA could increase even further based on a downgrade in the IFS score, even if the actual NRSRO investor credit rating

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remains unchanged. Rather than minimizing differences, the differences between the two capital frameworks would be increased, to the disadvantage of the non-Basel II banks.

Retaining the current 20% risk weight for GSE securities keeps the risk weighting system for GSE securities simple for most banks and minimizes the differences that could occur between the Basel II and the rest of the industry with regard to the treatment of these securities. **ICBA urges the agencies not to change the current 20% risk weight for GSE securities.**

Core Deposit Intangible Assets

In keeping with the stated policy objectives of Basel IA, ICBA believes that the recognition of the risk-mitigating benefits of contractual arrangements furnished by investment grade-rated third parties to cover risk exposures should be extended to core deposit intangible assets. Under current policy going back to 1994, the federal agencies single out the identifiable intangible asset associated with purchased core deposits for a complete deduction from regulatory capital. Since that time, acquirers of core deposits have demonstrated the ability to secure contractual rights from investment grade-rated third parties to re-sell (at their option) acquired core deposit bases for guaranteed premiums in excess of book value. These contracts satisfactorily address the original risk consideration identified in the 1994 regulatory rulemaking that core deposits may not be readily marketable.

For purposes of maintaining consistency with the Basel IA policy objectives of a) more accurately aligning capital requirements with risk exposures (in part through the recognition of third party guarantees from investment grade rated private sector entities) and b) addressing competitive inequities between Basel II and general banks, core deposit intangibles covered by such contracts that meet the requirements of a guarantee, should be included in regulatory capital. The other two common identifiable intangibles within the banking system – purchased mortgage servicing rights and purchased credit card relationships – are included in the calculation of Tier I capital. Those assets are typically acquired by Basel II size banks. A continuation of the disparate treatment of a similar asset that is subject to contractual protection would produce a policy outcome that is opposed to the stated policy objective of Basel IA.

Possible Alternatives for Basel II Banks

In both the Basel II and Basel IA NPRs, the agencies requested comment on whether the Basel IA proposal or the Basel II standardized approach would be a suitable basis for a regulatory capital framework for credit risk for Basel II banks.

ICBA continues to have serious concerns about the competitive effects of Basel II even if Basel IA is implemented. An FDIC study based on

QIS4 data indicates that even with the implementation of Basel IA, Basel II banks would require significantly lower risk-based capital requirements than the rest of the industry particularly with respect to residential mortgage, home equity and small business loans.[9] As noted above, since there is a cost to a bank for maintaining capital, the lower capital requirements would most likely result in a cost advantage, and correspondingly a pricing advantage, in retail credits for large banks that are subject to Basel II. ICBA also fears that Basel II will further accelerate the consolidation in the banking industry.

Because of the important role small and medium-sized institutions play in the economy by providing credit to consumers and small and medium-sized businesses, it is imperative that U.S. regulators carefully consider and address the competitive impact Basel II will have on second tier and community banks, and their customers. **To reduce the costs and complexity of Basel II, to enhance its flexibility, and mitigate competitive disparities between Basel I and Basel I banks, ICBA supports allowing Basel II banks the option of using the "standardized approach" in lieu of the advanced IRB approach.** ICBA believes that the use of the standardized approach by the Basel II banks would reduce the impact on risk-based capital by those banks and would mitigate to some extent, the competitive disparity between Basel I and Basel II.

ICBA strongly supports the decision by the agencies to maintain the capital-to-assets leverage ratio requirement for all banks, including Basel II banks. Retention of leverage ratios is essential to maintaining the safety and soundness of our banking system and is a needed complement to the risk-sensitive Basel II framework that is based only on internal bank inputs. It is also very important to our economy that regulators maintain a minimum capital cushion for our largest financial institutions that pose the greatest risks to our financial system.

ICBA commends the agencies for imposing a transitional floor on Basel II banks that would limit the reduction of their minimum risk-based capital requirement in any year to five percent, and for committing to fundamentally revise Basel II if, during the three-year transition period, there is a ten percent or greater decline in the aggregate minimum risk-based capital of Basel II banks. Any change of ten percent or greater would warrant a fundamental change to the Basel II rules.

During 2008—the year of the parallel run--ICBA recommends that the agencies conduct another study to determine the impact that a revised Basel I would have on minimum risk-based capital and whether the competitive disparities between the Basel I and Basel II accords would be mitigated by a Basel IA. If the new competitive impact study indicates a continuing competitive disparity between Basel II and Basel IA, then the three-year transition period should be put on hold until the regulators fundamentally revise Basel II. **If Basel**

[9] See footnotes 6-8 above for the FDIC study which shows the capital advantages that the Basel II banks will have even after the implementation of Basel IA.

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II cannot be revised to eliminate the competitive disparities, then the regulators should require that all banks either use Basel IA or Basel I.

Conclusion

ICBA strongly supports creation of the Basel I capital rules. ICBA has long advocated revising Basel I to make it more risk sensitive and to address any competitive issues with using a bifurcated capital system. The non-Basel II banks need a more risk-sensitive capital accord in order to be able to compete effectively with the Basel II banks. We particularly applaud the agencies for their proposal to allow the non-Basel II banks to opt-in to Basel IA. This will address the concern by many community banks that it would be more of regulatory burden than a benefit to opt-in to Basel IA.

ICBA strongly supports the use of additional risk-weight categories particularly for mortgage loans and endorses the idea of basing risk weights on LTV ratios. We support lower risk weight categories for both 1-4 family mortgages and stand-alone mortgages to better align capital requirements with actual credit risks and to minimize the different capital requirements between Basel II and Basel IA. While we acknowledge that pairing credit scores with LTV ratios might enhance the risk sensitivity of the mortgage loan risk weight categories, for most community banks the regulatory burden of including credit scores with LTV ratios would outweigh the benefits.

As for small business loans, we recommend that the agencies establish a 75 percent risk weight category for certain small business and commercial real estate loans that are under $2 million and support lower risk weights based on LTV ratios for small business, commercial real estate, and multi-family residential exposures that are fully collateralized by real estate.

Although ICBA also agrees with the concept of using external credit ratings to rate securities and credit exposures to enhance the risk-sensitivity of the Basel I risk-based capital rules, we strongly support keeping the current zero percent risk weight for short- and long-term U.S. government and agency exposures and the 20% risk weight for U.S. government-sponsored entities. To reduce the costs and complexity of Basel II, to enhance its flexibility, and to mitigate competitive disparities between Basel II and Basel I banks, ICBA supports allowing Basel II banks the option of using the "standardized approach" of the new accord in lieu of the advanced IRB approach.

However, even with Basel IA, ICBA still remains concerned about the competitive effect of Basel II and recommends that the agencies conduct an impact study during 2008 to determine if there is still a competitive disparity between Basel II and Basel IA. If the new competitive impact study indicates a continuing competitive disparity between Basel II and Basel IA, then the three-year transition period should be put on hold until the regulators fundamentally revise Basel II.

ICBA appreciates the opportunity to comment on the Basel IA NPR and to recommend improvements with the existing risk-based capital rules. If you have any questions about our letter, please do not hesitate to call me at 202-659-8111 or at Chris.Cole@icba.org.

Sincerely,

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