



**Testimony of**  
**America's Community Bankers**  
**on**  
**“An Update of the New Basel Capital Accord”**

**before the**  
**Committee on**  
**Banking, Housing and Urban Affairs**

**of the**  
**United States Senate**

**on**  
**September 26, 2006**

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**McHenry, Illinois**

**and**

**Member**  
**Board of Directors**  
**America's Community Bankers**  
**Washington, DC**

Chairman Shelby, Ranking Member Sarbanes, and members of the Committee, I am Kathleen Marinangel, Chairman, President & CEO of McHenry Savings Bank, a \$275 million community bank located in McHenry, Illinois. McHenry Savings Bank is a state-chartered, community financial institution serving customers in McHenry County in Northeastern Illinois. The bank currently operates five full-service banking offices. The primary business lines of the bank are focused on retail customers and small business owners, resulting in a diversified portfolio of single-family mortgages and commercial and consumer loans. We compete head-to-head throughout our market area with many large national financial institutions, including Washington Mutual, Citibank, JP Morgan Chase, Fifth Third, and TCF National Bank. We also compete with large foreign-owned banks such as Harris Bank, LaSalle Bank and Charter One.

I am submitting this statement on behalf of America's Community Bankers (ACB) of which I serve on the Board of Directors. I thank Chairman Shelby for calling this hearing on the Basel II and Basel IA proposals. The rulemaking process and the eventual implement of final rules are critically important to ACB member institutions.

### **Overview of Basel II and Basel IA**

ACB and its members took the early lead on the proposed regulatory capital changes affecting banks and savings associations. We believe that the development and implementation of Basel II and Basel IA are critically important regulatory initiatives for financial institutions today. We support the adoption by U.S. and international bank supervisors of a risk-based capital system that more accurately links the amount of capital

an institution holds to the risk taken by that institution. However, ACB remains concerned about the possible competitive impact Basel II will have on community banks when it is implemented in the United States. Furthermore, ACB is concerned that the complexity of implementing Basel II will place the large, internationally active U.S. banks at a competitive disadvantage vis-à-vis foreign banks that have been given a choice between the internal models version of Basel II and a more standardized approach.

Since the Basel Accord was first adopted in 1988, financial institutions have developed sophisticated tools to more accurately measure credit, interest rate, operations, market, and other risks. We believe that now is an appropriate time to review the current capital requirements that apply to all financial institutions and revise them to reflect changes in risk management that have occurred over the last decade.

In the United States, the federal banking agencies (Agencies) are working to update the Basel framework and create for the first time a bifurcated regulatory capital system. As currently contemplated, only about 10 financial institutions in the United States would be required to comply with Basel II. An additional 10 to 15 believe that they have the resources to voluntarily comply or opt-in. All other banks and savings associations would remain subject to Basel I or, as amended, Basel IA.

We commend the efforts of the Agencies to develop a Basel II proposal that is workable for the largest, internationally active U.S. banks. However, we strongly believe that Basel II should not be implemented unless changes are made to Basel I to more closely align

capital with risk for other depository institutions. Otherwise, we believe that Basel I banks would be left at a serious competitive disadvantage and would become possible acquisition targets for Basel II banks. Finally, ACB strongly recommends that small community banks continue to have the option to comply with Basel I in its current form.

We understand that the banking regulators expect to issue a Basel IA proposal in the near future. We also understand that the Agencies plan to substantially overlap the public comment periods for the Basel II and Basel IA proposals and that the proposals are expected to be implemented at the same time, allowing for the consideration of the overall capital framework for all banks. It is clear that the Agencies are listening to the industry's perspectives on Basel issues that affect an institution's capital requirements and business strategy. It is our hope that Basel II and Basel IA will establish a coordinated, more risk-sensitive capital regime without adding significantly to regulatory burden.

### **Basel II Accord**

Early in the process of developing a Basel II proposal, the Agencies determined that U.S. Basel II banks would use the "Advanced Approach," which would require each bank subject to Basel II to develop its own credit risk and operational risk models to determine capital levels. In contrast, banks in other industrialized countries are allowed by their regulators to choose between the methods described in the international Basel II Accord in order to determine capital requirements, including the "Standardized Approach." The Standardized Approach is simpler than the Advanced Approach.

In 2003, the Agencies requested public comment only on the Advanced Approach for determining capital levels. We are uncertain as to why the Agencies did not consider use of the Standardized Approach for U.S. Basel II banks.

We strongly believe that banks must have the opportunity to choose the capital calculation that best suits their business needs and risk profile and that Basel II banks be able to choose between the Standardized Approach or the Advanced Approach. The flexibility to adopt the Standardized Approach will help U.S. banks to compete both domestically and internationally with foreign banks that will be implementing Basel II in 2007.

ACB has significant concerns about the complexity of the Basel II proposal and the ability of financial institutions to bear the significant costs of accurate implementation of the proposal. We are also concerned with the capacity of the Agencies to adequately administer and enforce the new capital requirements without significant new reporting requirements. Furthermore, we are under the impression that there will be a substantial recordkeeping and reporting burden for institutions that would be subject to Basel II. We believe this is another reason that banks should be able to adopt the Standardized Approach for calculating capital. In addition to simplifying capital calculations, the Standardized Approach would allow banks to manage their reporting burden as well.

We are pleased that the FDIC board recently voted to seek public comment on whether Basel II banks should be permitted to choose between alternative methods for calculating

capital requirements.

In summary, ACB believes that prior to the final adoption of Basel II, the regulators and the industry need to evaluate the complexity of the proposal and the ability to monitor compliance. This would include greater consideration of the real-world consequences of adopting an extremely complicated capital regime, the resources needed for implementation, the problems inherent in ongoing maintenance, the likelihood of effective regulation and market oversight, and the competitive pressures that could potentially encourage banks to “game” the system.

### **Competitive Concerns for Community Banks**

Unfortunately, the complexity and costs associated with developing and implementing the models needed to measure and evaluate risk likely will preclude all but a small number of banks in the United States from opting into the more risk-sensitive capital regime proposed in Basel II.

The best available evidence suggests that Basel II will open the door to competitive inequities between large banks and community banks. The quantitative impact study, QIS-4, conducted by the Agencies showed that the Basel II Accord would result in significant capital savings for some of the largest banks in the United States and other countries. These large institutions compete head-to-head domestically with community banks in the retail area. Retail lending, particularly residential mortgage lending, is a fundamental business of community banks.

Under this bifurcated system, two different banks, a larger Basel II bank and a small Basel I community bank, could review the same loan application that presents the same level of credit risk. However, the larger bank would have to hold significantly less capital than the small bank if it makes that loan, even though the loan would be no more or less risky than if the community bank made the loan. Because capital requirements play a part in the pricing of loan products, the community bank may not be able to offer the same competitive rate offered by the larger institution. This result is not acceptable. Capital requirements should be a function of risk taken, and if two banks have very similar loans, they should have a similar required capital charge.

In addition, we are concerned that unless Basel I is appropriately revised, smaller institutions under a bifurcated capital regime will become takeover targets for institutions that can utilize capital more efficiently under Basel II. For instance, if a large bank could acquire a community bank's assets at a fraction of the required capital ratio imposed on the large bank, they would surely do so. The required capital at the acquired bank now would be excess capital under a Basel II structure. The bifurcated capital structure could drive acquisitions that otherwise would have no economic purpose.

Community banks must be permitted to utilize their capital effectively and judiciously while improving their ability to manage risk. Therefore, community banks must be given the choice to opt-in to the Basel II Standardized Approach, comply with a revised and

more risk-sensitive Basel IA, or continue to comply with the current Basel I framework if it better suits the institution's business needs and risk profile.

In short, the same capital options available to larger institutions must be available to smaller institutions and vice versa.

### **Creation of Basel IA**

In October of last year, the Agencies issued an Advance Notice of Proposed Rulemaking (ANPR) regarding possible changes to the capital framework to create Basel IA. ACB made many suggestions and observations in the comment letter we filed with the Agencies (See Appendix A). We look forward to studying and commenting on the Basel IA Notice of Proposed Rulemaking (NPR) that is expected to be published for public comment in the near future.

ACB has advocated in its letters to the Agencies and in previous testimony before Congress that the current Basel I capital regime be amended to take advantage of the ability of institutions and supervisors to measure risk more accurately.

Basel I fails to consider such risk factors as the loan-to-value ratio of collateralization and banks' significant nonfinancial assets. For example, a mortgage loan with a 20 percent loan-to-value ratio is risk-weighted the same as a mortgage loan with a 90 percent loan-to-value ratio. However, the risks associated with these loans are not the same. These are examples of elements of risk measurement that will be available to the banks that comply

with Basel II, while the vast majority of U.S. banks will have to comply with the outdated risk measurement, unless Basel I is amended.

As proposed in the ANPR, a revised Basel IA would include more risk buckets and a breakdown of particular assets into multiple baskets to take into consideration collateral values, loan-to-value ratios, and credit scores. Credit risk mitigation measures, such as mortgage insurance and guarantees, would be incorporated into the framework. Other revisions would be made to further refine current capital requirements. Such an approach would be relatively simple for banks to implement and for regulators to supervise.

We also believe that small community banks should have the option of continuing to comply with Basel I in its current form. We encourage the Agencies to allow institutions the flexibility to choose a model that best works for that institution. There are many smaller institutions that hold capital well in excess of minimum requirements and will continue to do so after Basel IA or Basel II is implemented. These institutions often operate in small communities, may be mutually owned, family-owned, or privately held. These institutions believe that higher capital is appropriate to their ownership structure. Institutions should not have to comply with the increased regulatory burden of changed capital requirements if they would prefer to remain compliant with a more straightforward, but a less risk-sensitive Basel I.

### **Leverage Ratio**

We understand that the Agencies intend to leave a leverage requirement in place. We

support the maintenance of a leverage ratio for all financial institutions and believe that a regulatory capital floor is necessary to mitigate the imprecision inherent in internal ratings-based systems. The results of QIS-4 raised significant concerns over the implementation of Basel II and the potential for a significant reduction of risk-based capital. That study was conducted with a group of U.S. institutions that are expected to adopt Basel II and showed evidence of large reductions in the aggregate minimum required capital. Because of this study, the Agencies agreed to a minimum aggregate decline of 10 percent per year and a leverage ratio floor of 5 percent in the Basel II proposal.

In 1991, Congress enacted FDICIA, which set out a requirement for a leverage ratio component in capital for U.S. financial institutions. Congress specifically set the “critically undercapitalized” level at 2 percent. While Congress left the other ratios to agency discretion, it is appropriate for Congress to oversee the implementation of a requirement it created. ACB suggests that the precise level of the leverage requirement should be open for discussion. Institutions that comply with Basel II, and institutions that comply with a more risk-sensitive Basel IA, may not achieve the full benefits of more risk-sensitive capital requirements if the current minimum leverage ratio remains unchanged. Absent changes to the current leverage ratio, institutions may make balance sheet adjustments based solely on capital requirements rather than on the best interests of the business.

In addition, ACB suggests that foreign bank supervisors should also consider adopting a

leverage ratio as a means of protecting their financial systems. This would be an important improvement to the original Basel Accord.

### **Capital Considerations Specifically Related to Business Lending**

ACB's comment letter to the Agencies' on the Basel IA proposal specifically stated the following as it relates to business and commercial real estate lending:

- We believe that risk criteria should be taken into account to differentiate loan types, include collateral characteristics and value, credit enhancements, LTV ratios, leasing commitments and structure, and other factors.
- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity.
- We propose that in order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the treatment of commercial real estate, institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk measures.
- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the Agencies to allow banks to use additional

types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.

## **Conclusion**

We wish to thank Chairman Shelby, Ranking Member Sarbanes and the rest of the Committee members in giving ACB this opportunity to present our views. As we mentioned at the outset, capital requirements for U.S. financial institutions are a critical component in the safe and sound functioning of the banking system, as well as the ability of U.S. banks to compete against each other and foreign banks. ACB stands ready to support Congress and the Agencies in implementing capital standards that more closely align capital to risk for all institutions.



January 17, 2006

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Attention Docket No. 05-16  
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Attention: Docket No. R-1238  
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[regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov)

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital  
Maintenance: Domestic Capital Modifications  
70 FR 61068 (October 20, 2005)

Dear Mesdames and Sirs:

America's Community Bankers ("ACB")<sup>1</sup> is pleased to comment on the joint advance notice of proposed rulemaking ("ANPR") issued to solicit comments on changes to the risk-based capital framework for depository institutions in the United States.<sup>2</sup> The revised framework would apply to those banks and savings associations that are not required to comply with, nor are able to opt-in to, the revised Basel Capital Accord developed by the Basel Committee on Banking Supervision at the Bank for International

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<sup>1</sup> America's Community Bankers is the member-driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit [www.AmericasCommunityBankers.com](http://www.AmericasCommunityBankers.com).

<sup>2</sup> 70 Fed. Reg. 61068 (October 20, 2005).

Settlements (“Basel II”). This ANPR would lead to the issuance of a notice of proposed rulemaking at or near the time that the agencies also issue a notice of proposed rulemaking for Basel II.

### **ACB Position**

We are pleased that the agencies have taken this step to revise risk-based capital requirements for all depository institutions. We believe that now is an appropriate time to review the current capital requirements that apply to everyone and revise them to reflect the changes in risk management and operations that have occurred over the last decade. Also, as we have made clear in our comment letters on the Basel II proposal and at Congressional hearings, we strongly believe that Basel II should not be implemented unless changes are made to Basel I for other depository institutions. Otherwise, we believe that Basel I banks would be left at a serious competitive disadvantage and also would become possible acquisition targets for Basel II banks.

You will note that our comments discussing different asset categories generally argue for more risk buckets and the ability of an institution to choose how much burden they wish to incur in exchange for more risk-sensitive capital requirements. We believe that more buckets provide greater ability to differentiate risk among loans in a certain asset category. However, we would encourage the agencies to allow institutions some flexibility in choosing a model that best fits their needs and matches their resources. For some institutions, the process of collecting, updating and reporting borrower and loan characteristics that are relevant barometers of risk will not be too burdensome. Other institutions may prefer simpler, more straightforward capital requirements, as are prescribed under existing Basel I standards.

The following is a summary of our position on the many questions contained in the ANPR, with more detail on each of these topics provided in the remainder of this comment letter.

- ACB strongly supports risk buckets based on loan-to-value (“LTV”) ratios for one-to-four family residential mortgage loans. If other risk criteria, such as credit scores and debt-to-income ratios are to be included in a revised Basel I, they should be optional for those institutions that wish to incur additional burden in order to have capital requirements even more closely aligned with risk. We support the use of private mortgage insurance (“PMI”) to reduce the numerator in the LTV ratio. There should not be different treatment for what the ANPR refers to as “non-traditional” mortgage products. We also provide an alternative approach to the proposed treatment of second lien mortgages.
- The risk criteria that should be taken into account to differentiate multifamily residential mortgages should be LTV ratios and number of units. A similar approach to the buckets for single-family residential mortgage loans should be used to stratify these mortgages based on risk.

- The collateral value for automobile and other secured consumer loans should be taken into account to differentiate these loans by LTV ratios. The agencies should consider allowing an option for banks to also use the loan term, credit scores and debt-to-income ratios for other types of unsecured retail loans to attain an even more accurately aligned risk weighting.
- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. In order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the treatment of commercial real estate, we believe institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk drivers.
- We believe that it is appropriate to provide a lower risk-weight for small business loans that have lower LTV ratios based on the value of eligible collateral, no defaults and full amortization over a seven-year period. Two or three buckets should be available to institutions that are willing to incur more burden, with loans slotted based on LTV ratios and loan term. An alternative could also be offered that would allow an institution to adjust the risk weighting based on the credit assessment of a shareholder guarantor. Small business loans should be defined as those loans under \$2 million on a consolidated basis to a single borrower.
- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the agencies to allow banks to use additional types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.
- We believe the substantial cliff effect that occurs for short-term commitments should be removed by applying a credit conversion factor of 20 percent to all commitments regardless of term. This should not apply, however, to commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation. These commitments should have a zero credit conversion factor.
- We do not support an increase in risk weighting for past due loans. Current regulatory requirements provide that depository institutions set aside reserves and take other steps to mitigate the risk of these loans and their impact on the

institution. Also, an automatic upward adjustment without consideration of LTV ratios would not be appropriate.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.
- We strongly believe that a leverage ratio should remain in effect.
- The agencies should consider developing, or encouraging third parties to develop, a simplified risk-modeling system that could be used by less complex banks to establish minimum capital requirements.
- Depository institutions of any size that would prefer to remain subject to Basel I as it currently exists should have the option to do so. Also, institutions should be provided flexibility to utilize some of the fundamental principles in a revised Basel Ia approach to gain a more risk-sensitive capital approach without undue burdens.

### **One-to-Four Family Residential Mortgage Lending**

*Risk-Weight Categories.* The agencies are contemplating revising the 50 percent risk weighting for all mortgage loans that would adjust the risk weight based on LTV ratios. ACB strongly supports this approach. LTV ratios historically have been a strong indicator of risk, are readily available to community banks, and can be updated fairly easily even if on a quarterly basis. We believe that the numerator of the LTV ratio should be based on the net balance carried on the books of the institution to take into account any discount on purchased loans. Net balance reflects the true exposure of the institution.

With regard to updates of LTV ratios, we believe that the denominator should be based on the appraisal of the property obtained at the time of the loan closing. However, institutions should be given the option of updating the appraisals if they would like to undertake that burden to get capital requirements even more closely aligned with changing risk.

With regard to other loan characteristics that might reflect risk, our members have various opinions with regard to whether credit scores or debt-to-income levels would be more appropriate to put into a matrix with LTV ratios to determine risk. Most of our members believe that the LTV ratio is the best indicator of the risk of a mortgage loan and that credit scores or other ratios could be used in combination with LTV ratios, but should not be used in isolation. Credit scores and debt-to-income ratios provide valuable information and are appropriate indicators of a borrower's ability to repay a loan and, therefore, the risk level of the loan. We know of no study that shows which alternative,

credit scores or debt-to-income ratio, is a better indicator of risk, so a proposal could offer the opportunity to use one or the other or both in the matrix.

There is some concern that any requirement to update the information with regard to credit scores or debt-to-income levels would be too burdensome for many community banks. Therefore, we support an approach that would permit those institutions that wish to include these characteristics in their risk assessment be permitted to do so in accordance with any parameters established by the agencies. This gives institutions the greatest flexibility to choose the level of risk sensitivity that is appropriate to the amount of burden they wish to incur.

The ANPR references “non-traditional” mortgages and questions whether these loans should be treated in the same matrix as traditional mortgage products or whether they pose unique and greater risks that warrant higher capital charges. Our members strongly believe that all single-family residential mortgages should be treated the same under the capital framework. As an initial matter, it is unclear what products would be considered non-traditional mortgages in the current environment where the types of mortgage loans made in the past may not be the only ones appropriate in a more mobile society that manages finances and debt differently. Many of our members have several decades of experience with a whole range of mortgages, including adjustable rate and other alternative products, and this experience has occurred through times of significant economic stress. Any capital proposal should draw upon this actual experience when developing relevant risk weightings.

Our members feel that LTV ratios are the best indicator of risk for any single-family mortgage loan, notwithstanding the characteristics of the loan. Similarly, credit scores and debt-to-income ratios are calculated in the same way for all types of mortgage loans and are applied differently only in the sense that a higher or lower credit score or debt ratio may be required for different types of products.

*PMI.* The agencies have questioned whether there should be certain limits on the use of PMI to decrease the numerator in LTV ratios. We understand there could be some concern with the ability of PMI companies to honor commitments during a time of economic stress. Therefore, we support the approach that would recognize PMI only if it is written by a highly rated company. ACB believes that pool insurance and other types of guaranty programs do help reduce risk and should be considered in risk weighting mortgage loans. We suggest that the agencies recognize these risk mitigation methods consistent with the recourse provisions in the agencies’ capital guidelines on asset securitization. Also, mortgage insurance protection provided under special policies for loans sold to a Federal Home Loan Bank under its mortgage purchase program should be fully recognized when determining capital requirements for recourse obligations associated with those sold loans.

For the reasons discussed above, we believe that PMI should be recognized for all types of mortgage products, without regard to the characteristics and terms of the mortgage. We see no reason to treat certain mortgage loans differently if they are covered by PMI.

Nor do we see a need for risk-weight floors if PMI will be recognized only if written by highly rated companies.

*Second Liens.* The proposal discusses the treatment of second liens, which would differ depending on whether the institution also holds the first lien on a property. If an institution holds a first and second lien, including a home equity line of credit (“HELOC”), the loans can be combined to determine the LTV ratio and the lender can apply the appropriate risk weight as if it were one first lien mortgage. We believe that institutions should have the choice to treat first and second liens as separate risks. The first lien carries less risk and is more likely to be repaid in full, so it should carry a lower risk weighting than the second lien. For example, a first mortgage with an 80 percent LTV should not have its risk-weight adjusted from 35 percent to 100 percent if the borrower also carries a second bringing the LTV to 95 percent. Such an effect will likely cause the lender to be less willing to extend the second lien, forcing the borrower to utilize alternative lending sources and incurring much higher borrowing costs/fees in obtaining the second mortgage.

For stand-alone seconds or HELOCs, if the LTV at origination for the combined loans does not exceed 90 percent, the agencies propose a 100 percent risk weighting. If the LTV is over 90 percent, the agencies believe a risk weight higher than 100 percent would be appropriate. We do not support this approach. Again, the weighting should be more closely aligned with the actual risk. It should not be set in a way that forces lenders to forego second liens because the capital requirements are not proportional to the risk. The result of the proposal is that if the lender holds a first mortgage with an 85 percent LTV, that loan would have a risk weight of 50 percent. If the lender holds only a second mortgage where the combined LTV is 85 percent, the risk weight for the second mortgage is doubled to 100 percent even though the risk is the same based on an LTV ratio. We do not believe this is the proper result.

Capital treatment of first and second liens, regardless of whether the same institution holds both, should be consistent to avoid gaming of the system or unnecessary burdens on borrowers who might have to spend more time and money securing second mortgages. We also believe that PMI should be factored in when determining the risk weight of a second lien just as it would be for a first lien.

### **Multifamily Residential Mortgages**

Multifamily residential mortgages currently receive a risk weighting of 100 percent, except for certain seasoned loans that may qualify for a 50 percent risk weighting. The agencies are seeking comments and supporting data as to whether there are ways to differentiate among these loans with regard to risk.

We believe that a stratification of these loans into three or four risk buckets, similar to single-family residential loans, would be appropriate. We recognize that the risk weighting for these loans would have to take into account the higher risk of this type of lending. Since LTV ratios are the most accurate predictor of a mortgage loan’s risk, we

believe that the buckets should primarily be based on these ratios. However, we also believe that the number of units financed also should be considered. For example, loans could be classified as fewer than 20 units, 20 to 36 units, and more than 36 units. The number of units is correlated with the size of the loan and the size of the loan is associated with risk. Appropriate risk weight buckets could be determined by consulting with banks and savings associations experienced with multifamily residential mortgage lending through periods of economic stress.

### **Other Retail Loans**

The agencies have requested information on alternatives for structuring a risk-sensitive approach for consumer loans, credit cards and automobile loans.

We believe that LTV ratios for automobile lending and other secured consumer lending should be used to differentiate risk at the option of the institution. There are objective, standard resources for determining the value of an automobile. Other types of collateral that have objective means for determining value also should be considered. Those institutions that are willing to collect, update, and report this information should have the option of using LTV ratios to better align capital requirements with credit risk.

For automobile loans, credit card lending, and certain types of unsecured consumer loans, loan term can be used to differentiate risk, with less risk assigned to shorter terms. Credit scores or debt-to-income ratios also could be used to differentiate risk at the discretion of the institution. As with mortgage loans, there is no evidence indicating which measure is more accurate as a barometer of risk. Those institutions that are willing to collect, update, and report this information should have that option. Other institutions that would prefer less burden should be able to comply with simpler, more straightforward requirements such as risk weights based only on LTV ratios and loan term.

### **Commercial Real Estate Exposures**

The agencies have long had supervisory concerns with loans made for the acquisition, development and construction (“ADC”) of commercial property. Currently, these loans are subject to 100 percent risk weighting. The agencies are considering increasing the risk weight above 100 percent unless the loan meets certain conditions, including complying with interagency real estate lending standards and having long-term borrower equity of at least 15 percent. The agencies request comment on this approach and also on whether there are other types of risk drivers, such as LTV ratios or credit assessments that could be used to differentiate the risk of these loans.

We understand the concerns that the agencies have had with commercial real estate loans. However, capital requirements should be proportionate to the risk to ensure that prudent ADC lending is not discouraged. Our main objective in this area would be that Basel I banks be treated as similarly as possible to Basel II banks. This is a primary area of lending where our member community banks compete with the larger banks and they should not be left at a competitive disadvantage.

We support the approach in the proposal that would provide lower risk weights for loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. LTV ratios and other drivers of credit risk, such as loan term and borrower equity, should be considered, at the discretion of the institution. This could be done by slotting these loans into two or three buckets with different risk weights based on the characteristics of the loan and the additional risk drivers.

There have been concerns among our members that the general reference to ADC loans in the ANPR could be interpreted to include loans to residential real estate developers. ACB would strongly oppose the application to residential ADC loans, as these types of loans do not involve the same type of risk as more speculative loans to commercial builders. We would appreciate having clarification that these ADC provisions would not apply to single-family homebuilders and developers.

### **Small Business Loans**

Small business loans currently are assigned to a 100 percent risk-weight category unless covered by acceptable guarantees or collateral. The agencies are considering reducing the risk weight for small business loans to 75 percent if certain conditions are met, such as full amortization of the loan within seven years, no default in contract provisions, full collateral coverage, and application of appropriate underwriting guidelines. Small business loans would be those loans under \$1 million on a consolidated basis to a single borrower.

An alternative approach would be to use a risk weight based on the credit assessment of the principal shareholders and their ability to service the debt when the shareholders provide a personal guarantee.

We support the proposed approach that would provide lower risk weights for small business loans that meet certain conditions, such as compliance with appropriate underwriting guidelines, no defaults, and full amortization over a seven-year period. We question, however, whether full collateral coverage should be required. We would prefer an approach that provides two or three different buckets based on LTV ratios, with lower ratios receiving lower risk weights. To provide even more alignment with risk, loans could be slotted into buckets based on the loan term, with shorter terms receiving a lower risk weight.

An alternative option could be offered that would allow an institution to base the risk weight on the credit score or debt-to-income ratio of a principal shareholder that guarantees the loan. Again, multiple buckets should be offered based on the results of the credit assessment.

We believe that the definition of small business loan should be changed to include those loans under \$2 million on a consolidated basis to a single borrower. This would be

consistent with the clear definition of “small business loan” provided in the OTS lending and investment regulations.

Any approach that would revise the risk weights for small business loans should be optional to the institution. Only those institutions wishing to incur the burden of collecting, updating and reporting relevant information in exchange for more risk-sensitive capital requirements should have to incur any increase in burden. Some institutions may find that maintaining and reporting data on loan terms for small business loans may not warrant the requirement to maintain, update and report on collateral value and LTV ratios. Other institutions may find it less burdensome to rely on a guaranteeing shareholder’s credit assessment. It is better to provide as much flexibility as possible without over-taxing the resources of the institutions or the agencies.

### **Use of External Credit Ratings**

The agencies propose allowing institutions to assign risk weights for certain assets by relying on external credit ratings publicly issued by a recognized rating agency. For example, a commercial loan to a company with the highest investment grade rating would have a 20 percent risk weight, while the lowest investment grade rating would receive a risk weight of 75 percent. Exposures with ratings below investment grade could receive a capital charge up to 350 percent. The agencies would retain the ability to override the use of certain ratings, either on a case-by-case basis or through broader supervisory policy.

We do not support the use of external credit ratings in determining the risk of commercial loans without some comparable method for determining the risk of unrated companies. Ratings are designed to measure the likelihood of default, but not the likelihood of a loss. The rating also does not reflect the fact that an institution may have purchased the loan at a discount. Many community bank commercial loans are made to businesses that are not assigned credit ratings, but are good credit risks with low probability of default. It would be unfortunate if capital requirements discouraged lending to very strong companies who help create jobs in the community simply because the company is not rated by a recognized rating agency. We support capital requirements for commercial loans that are simple, encourage approval of loans to creditworthy, unrated businesses, and avoid any competitive disadvantage to the community banks that make most of their commercial loans to unrated companies.

We would support recognizing additional types of collateral and slotting these loans into risk buckets based on LTV ratios to differentiate the risk of commercial loans. There are objective sources available to calculate value for collateral such as real estate and equipment. Financial collateral, such as certificates of deposit held at other institutions, also could be considered.

### **Short Term Commitments**

There currently are no risk-based capital requirements for commitments lasting less than one year. For commitments greater than one year, the commitment is converted to an on-balance sheet credit equivalent using a 50 percent credit conversion factor (“CCF”).

The agencies are considering applying a 10 percent CCF for short-term (less than one year) commitments, with the amount then risk-weighted according to the underlying asset. This would not apply to commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation based on credit deterioration. An alternative suggestion is to apply a CCF of 20 percent to all commitments, whether short or long term.

We believe the substantial cliff effect that occurs with short-term commitments should be removed by applying a CCF of 20 percent to all commitments regardless of term. Commitments that are unconditionally cancelable at any time or that effectively provide for automatic cancellation should have a CCF of zero.

### **Past-Due Loans**

The agencies are considering assigning higher risk weights to exposures that are 90 days or more past due and those on nonaccrual. The amount at risk, however, would be reduced by any reserves directly allocated to cover potential losses on the past-due exposure.

We do not support this approach. Current regulatory requirements provide that depository institutions set aside reserves and take other steps to mitigate the risk of these loans and their impact on the institution. The proposal does not take into account the improvements to risk management systems developed by lenders that call for quick intervention to resolve payment issues. Finally, automatic upward adjustments for past due loans do not take into account LTV ratios or other relevant risk drivers that could reduce the amount of loss upon default.

### **Use of Collateral and Guarantees to Mitigate Risk**

The agencies propose to allow greater use of collateral and guarantees to reduce the capital requirements for exposures. Currently, the only collateral recognized in the capital rules is cash and certain government, government agency and government-sponsored enterprise securities. The list of recognized collateral would be expanded to include short- or long-term debt securities that are externally rated by a recognized rating agency. Portions of exposures collateralized by these instruments would be assigned to risk-weight categories according to the risk weight of the instrument. To recognize more types of collateral, an institution would need a collateral management system in place that tracks collateral and can readily determine its value.

The agencies also are considering increasing the types of recognized guarantors. The list would be expanded to include entities whose long-term senior debt has been assigned an external credit rating of at least investment grade. We believe that any expansion of the types of eligible collateral and the use of guarantees could be useful, but this should be optional, as some institutions may find tracking of collateral and the management of guarantees to be overly burdensome and unjustifiable. Also, the institutions that would benefit from such a change are those that take externally rated collateral or get guarantees from rated organizations. Many community banks do not take collateral in the form of rated securities. Also, although many of our members get personal guarantees for small business loans and commercial loans, these guarantees are from individual shareholders and not guarantors with externally rated long-term senior debt. We do not believe that allowing the use of externally rated debt securities and guarantors in order to get more risk-sensitive capital requirements will change the behavior of community banks with regard to how they underwrite and collateralize small business and commercial loans.

As discussed above, we think the types of recognized collateral should be expanded to include other items types of collateral that are used to secure commercial loans and that have objective sources of valuation. This would include real estate and industrial equipment as well as financial collateral such as certificates of deposit held at other institutions.

### **Leverage Ratio**

The regulators propose to keep the leverage ratio requirement in place for both Basel I and Basel II institutions. We believe that a regulatory capital floor must remain in place to mitigate the imprecision inherent in the internal ratings-based system to be used by Basel II banks and to provide a safeguard for Basel I banks. However, the precise level of the leverage requirement should be open for discussion, so that consideration might be given to allow institutions that comply with Basel II and Basel I-A to more fully achieve the benefits of more risk-sensitive capital requirements.

### **Risk Modeling Approach**

We would like the agencies to consider establishing a simple risk modeling system for use by community banks, much like the OTS developed for interest rate risk modeling used by savings associations. The modeling approach could establish capital levels that more clearly reflect each institution's actual risk levels without adding the significant costs of implementing the more sophisticated approaches in Basel II. An alternative might be a private industry approach whereby third party vendors could develop simplified internal ratings-based systems subject to regulatory review. This would give smaller institutions the proper incentive to improve their risk management and measurement systems, notwithstanding the fact that they do not possess the expertise to develop such systems internally. If such an approach is not deemed to be practical for all asset categories, it could at least be considered for commercial loans. Such a modeling approach could be based on similar ratings systems established by private, third-party firms that are readily available for business loans.

## **Other Issues**

We support the use of more risk weight categories and the ability to more accurately differentiate among all balance sheet assets, not just those mentioned in the ANPR. For example, certificates of deposit of less than \$100,000 held in insured depository institutions and similar correspondent bank deposits should receive a zero risk weighting, rather than the current 20 percent. Land and buildings could get lower risk weights based on appraised and net book value. Accrued interest on loans could be slotted in the same bucket as the loan itself.

We believe that institutions that prefer to remain on Basel I, without additional changes, should be permitted to do so regardless of size. There are some institutions that do not see the need, either from a management and operational perspective or a competitive perspective, to have more risk-sensitive capital requirements. For these institutions, the choice to avoid any regulatory burden associated with changes to the capital requirements should be respected. We see no reason why this choice should be limited to institutions of a particular size. Regulators are accustomed to supervising compliance with current Basel I. To the extent a significant number of institutions choose to remain subject to Basel I without change, this could also reduce the burden on the regulatory agencies.

We also believe that institutions should be afforded some flexibility in the approach used to obtain more risk-sensitive capital requirements. For many of our members, the ability to have more risk-sensitive capital requirements only for residential loans would be sufficient to mitigate any competitive disadvantage they would face with regard to Basel II banks. Some institutions may be interested in more risk-sensitive capital requirements only if it comes without significant burdens to compliance. Other institutions are willing to spend significantly more initial resources in order to attain capital requirements that can be even more closely associated with risk. For instance, some of our members may be satisfied with weighting the risk of their mortgages solely by LTV ratios, while others may be willing to incur greater burden by also taking into account credit scores or debt-to-income ratios. We believe that the more flexibility that can be provided, without unduly burdening the regulatory agencies, the better it is for the industry.

The agencies also should consider whether the creation of a risk-sensitive Basel 1-A could be applied to the entire industry, rather than single out some of the largest banks for compliance with Basel II. In light of the implementation issues that have arisen with Basel II, and ongoing concern about the use of sophisticated internal ratings-based models in the advanced approach to determine capital requirements, one overall framework may be a more useful and appropriate approach. At a minimum, we believe that Basel II banks should be allowed to utilize the Basel I-A model as a floor during the three-year implementation phase of Basel II.

Our members understand that in order to get the benefit of more risk-sensitive capital requirements, they will have to provide more information to the agencies on Call and Thrift Financial Reports. However, we believe that the changes made to the reports

should be limited to those necessary for the agencies to adequately supervise compliance with the capital requirements. We also believe that it is important to give institutions choices, so that they can decide to adopt only certain changes to capital requirements in order to keep their reporting burden in check.

ACB appreciates the opportunity to provide this comment letter and intends to remain engaged on this important matter. If you have any questions, please contact the undersigned at (202) 857-5088 or via e-mail at [rdavis@acbankers.org](mailto:rdavis@acbankers.org), or Sharon Lachman at (202) 857-3186 or via e-mail at [slachman@acbankers.org](mailto:slachman@acbankers.org).

Sincerely,

A handwritten signature in black ink that reads "Robert R. Davis". The signature is written in a cursive, flowing style.

Robert R. Davis  
Executive Vice President and  
Managing Director, Government Relations