October 27, 2008

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street & Constitution Ave., NW
Washington, DC 20551

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219

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

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attention: OTS-2008-0002

Re: Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework; 73 Federal Register 43982; July 29, 2008; **OCC:** Docket ID: OCC-2008-0006, RIN 1557-AD07; **FRB:** Docket No. R-1318; **FDIC:** RIN 3064-AD29; **OTS:** Docket No. 2008-002, RIN 1550-AC19

Ladies and Gentlemen:

Second Pillar Consulting is pleased to comment on the Notice of Proposed Rulemaking (NPR) issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (together, the Agencies) that proposes new Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework (henceforth, "Standardized NPR").

Second Pillar Consulting is a small consulting firm dedicated to helping community and regional banks comply with Standardized Basel II regulation. We also help community and regional banks manage their regulatory capital exams and enterprise risk positions.[1] Having prepared larger domestic and foreign institutions for Basel II prior to our work with smaller institutions, we possess a somewhat unique perspective on the developing capital adequacy rules. We hope our perspective proves useful to the Agencies as they move to finalize this regulation.

The attached comments are divided into three sections. First, we provide our general observations on the proposed regulation. Second, we provide comment on specific features of the proposed rule. Finally, we summarize our recent research on the impact of Standardized Basel II. We are deeply convinced that Standardized Basel II is superior to the existing General regime and that it should be swiftly finalized. Throughout the existing financial services crisis, community and regional banks have proven a resilient and reliable component of the larger system. They deserve the prudent, effective, and

[1] More information on our firm and copies of our Basel II research can be found at www.secondpillar.com

meaningful regulatory regime that -- properly implemented -- Standardized Basel II can become.

Please do not hesitate to call on us if we might provide any additional information or assistance.

Sincerely,

(signed)
Geoffrey Rubin, Ph.D.
Principal

(signed)
William Nayda, Ph.D.
Principal

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Response to the U.S. Notice of Proposed Rulemaking

Risk-Based Capital Guidelines;
Capital Adequacy Guidelines: Standardized Framework

Second Pillar Consulting

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I. General Observations

Our general observations about Standardized Basel II and the larger effort to improve capital regulation:

1. Basel II philosophy – that regulatory capital requirements should reflect risk – is sound even in the face of current market turmoil. Some have fingered Basel II as a possible culprit in the crisis, but any criticism of this regulation should be levied at its *methods* rather than *philosophy*. One can question any particular method for measuring risk, and we agree that certain definitions and measures of risk incorporated in Basel II can be improved. But the flaws of risk models should not undermine the greater aim of enhancing the risk-sensitivity of capital regulation. The risk "genie" cannot be stuffed back into the bottle; even after this crisis passes, financial institutions will adopt strategies that reflect a range of risk appetites. Holding riskier banks to the same capital standard as their safer counterparts is folly. Choosing to ignore the differentiated risk across institutions will only further imperil the financial system, for banks will quickly find themselves in a "race to the bottom" of the credit curve in search of yield. The real cause of the current crisis was a fundamental *under-appreciation* of risk. This is no time to turn our back on risk-sensitive regulation. Instead, we should embrace this philosophy and strive to improve the methods and oversight that will make it most useful.
2. Appropriate conception and application of Pillar Two is the key to the success of this regulation. The proposed Pillar One rules are somewhat more risk-sensitive and accurate than General regime rules, particularly in the areas of residential mortgage and the investment portfolio. But for the preponderance of community and regional bank balance sheets – consumer loans and unrated CRE and C&I exposures – the proposed Standardized rules offer no more risk-sensitivity than existing rules. These shortcomings are no great shame; the modeling and expression of risk in regulatory formulae is an inherently imperfect process, and even the tentative steps taken in Pillar One are positive if incomplete. The real power of this regulation lies in the potential of Pillar Two. Properly executed, Pillar Two can align capital with risk and elevate the role of risk and capital management at institutions large and small. Our suggestions on how to best implement Pillar Two:
    a. Enforce philosophical consistency across charters and sizes. Pillar Two should consider the same elements for each bank, no matter their charter, size, or complexity. Board oversight, capital contingency planning, target setting, modeling governance, and third-party review are among the items that any Pillar Two exam should consider. Only the techniques employed should vary with institutional size and complexity. The demonstration of capital adequacy, for example, should be required of all institutions, but economic capital modeling need not always be employed. We found the Standardized NPR description of Pillar Two quite inhibited relative to previously issued guidance for Advanced Basel II. We hope this only belies a difference in expected technique rather than philosophy. Pillar

Two should mandate true ownership of and commitment towards capital adequacy, no matter the regulatory regime or bank type.

   b. Regulators should emphasize the capital plan and its integration with a strategic plan. Pillar One provides a current (or, in the case of the operational risk charge, a dated) snapshot of capital adequacy, so Pillar Two should focus on the prospective adequacy of the capital position. This is best accomplished by considering capital within the larger context of the bank's strategic plan: how is the balance sheet and the environment changing, how will the product mix evolve, what new products or customers will be emphasized, how is competition affecting pricing. The dynamics of capital adequacy have never been more fluid as now, so it seems entirely appropriate for regulators to require demonstrated forethought and planning.
   c. Invest in and empower field examiners. Pillar Two, done properly, might be unfamiliar territory for many field examiners, including those that work with smaller institutions. A version of Pillar Two reduced to a checklist will prove unsatisfying, so the agencies should ensure that their field staff are prepared to probe the full depth and breadth of the capital adequacy problem. Examiners should also be empowered to act upon their well-informed convictions. For example, examiners should be prepared to demand greater control and ownership of the capital plan at the board and senior management levels. They should also be authorized to both increase *and* reduce Pillar One requirements, where appropriate.
   d. Pillar Two is so important to the safety and soundness of U.S. institutions, we encourage the agencies to immediately lever existing regulations such as SR 99-18 to effect the spirit of Pillar Two across the entire system.
3. As proposed, Standardized Basel II places no great burden on any bank, even the smallest. Most Pillar One calculations are no more complex than those required under current rules, and in those areas of greater complexity (derivatives and collateral), the NPR always provides a simple option. Expanded data requirements are somewhat more challenging. Maintaining home values for the new LTV calculations might require an investment, as might the need to aggregate certain exposures on a customer- rather than loan-level to qualify for regulatory retail treatment, but these are affordable for even the smallest institutions. Institutions can also readily implement Pillar Two as long as examiners show appropriate restraint in requiring techniques such as economic capital modeling. The ability to demonstrate the adequacy of one's capital should not lie beyond the capabilities of any U.S. bank.
4. Finally, we urge the agencies to implement Standardized Basel II as soon as prudently possible. Tying the Standardized effective date to coincide with the entrance of an Advanced institution into the first transition period in some sense degrades the Standardized regime. We feel that Standardized is a legitimate, viable regulatory regime that improves upon existing rules and should be immediately adopted, no matter the pace of Advanced adoption. The agencies risk sending a message that Standardized is but a political bone that need only be thrown to smaller institutions at such a time as larger institutions get their new

regime. The Standardized regime is much better than that, and the agencies can demonstrate similar beliefs by moving it quickly into practice. In fact any further delay puts US institutions at a competitive disadvantage to foreign counterparts operating in the US. The five largest Canadian banks, for example, have already seen their risk capital ratios rise approximately 7% after adoption of Basel II.

II. Specific Comments on the Proposed Rule

We endorse the positions of both the Risk Management Association and the American Bankers Association and encourage the Agencies to heed the recommendations and observations contained in the letters of both organizations. Rather than re-iterate the positions expressed in those letters, we highlight those areas we find particularly urgent.

1. The proposed Basic Indicator Approach (BIA) for assessing operational risk capital is severely flawed and might undermine the entire Basel II exercise. Gross income is a highly dubious proxy for actual operational risk. While we strongly support risk-sensitivity, this simple model of risk is patently false and should be abandoned. Applying the same operational risk charge to all banks is much better policy than moving forward with the existing BIA proposal. At a minimum, the Standardized Approach (SA) and, even more importantly, the Alternative Standardized Approach (ASA) should be permitted. Allowing the ASA will at least keep the regime viable for high margin, high loss banks; unless forced, no such bank will adopt Standardized Basel II because of the punitive BIA operational risk capital charge. There is a further problem with the calibration of the BIA 15% co-efficient on gross income. The conversion of operational risk capital into a risk-weight at the international 8% minimum rate, and re-conversion back into capital at the de facto U.S. 10% minimum rate, has the effect of inflating operational risk capital by 25%. We know of no meaningful calibration of the 15% coefficient but, to the extent it has merit, it should be reduced to 11.25% in the U.S. for the effect just described. Still, this just dresses a particularly flawed window. BIA represents the worst of capital regulation and is the type of arbitrary rule for which regulators should expect significant criticism. Allowing SA and ASA is slightly better, as is the application of a flat-rate charge. But the best approach is to empower examiners to build an operational risk capital charge in Pillar Two, using elements of the Advanced Measurement Approaches (AMA) that subsume risk management and insurance coverage. Such an approach would provide the *meaningful* risk-sensitivity that is absent in BIA.
2. The LTV upon which residential risk-weights are assigned should incorporate current, rather than origination, property value. Existing value is clearly the relevant economic variable and the one that drives credit risk. In times of deteriorating property values we expect regulators will require updated appraisals; banks should have a similar option to update appraisal values during periods of appreciation. Ignoring current property value can have the pernicious regulatory arbitrage implications that we study in detail in our paper "Capital Arbitrage Across and Within the Various U.S. Regulatory Capital Regimes," RMA Journal, November 2008. These include:

   a. The transfer of safe, seasoned mortgages from the balance sheet through securitization or sale to parties (including Advanced banks and unregulated institutions) that face no restrictions on what information they might consider in assessing risk. Low-risk, seasoned residential mortgage is precisely the type of product that regulators should want small banks to hold. The use of origination property value undermines this aim during normal periods of price appreciation.
   b. Use of straw transactions such as one-dollar junior liens that allow banks to obtain updated appraisals that can be used to re-adjust the LTV of the existing loan.
3. The Standardized NPR expansion of permissible collateral to include financial collateral is admirable but incomplete. All forms of collateral should be recognized, including inventory for businesses and cars/boats/personal effects for consumers. Regulation that ignores the risk-mitigating nature of non-financial collateral will a) do nothing to encourage institutions to request these risk-mitigating features, and, b) encourage institutions to abdicate this business to institutions that face no restrictions in the types of collateral they can consider. Non-financial collateral provides a real economic benefit that the Standardized rule should reflect.

III. Our Standardized Basel II Research

We recently authored a pair of papers that examine two distinct aspects of the Standardized NPR.[2] We briefly summarize our findings here and provide some additional color on Standardized Basel II.

The Impact of Standardized Compliance on Regulatory Capital Ratios. Our first area of research sought to quantify the impact of Standardized Basel II on bank capital ratios. Using the text of the July NPR and 2008Q1 public call report / TFR data, we developed estimates of the tier one and total risk-based capital ratios that banks might expect under Basel II. In those areas that NPR calculations require data not available in call reports, we relied upon certain assumptions. For example, we assume that the distribution of LTV's within each bank's first-lien mortgage portfolio matches that found in the 2004 Survey of Consumer Finances.

Overall, we found that about ¾ of all U.S. banks and thrifts see some improvement in their capital ratios under Standardized. We also estimate that the median institution enjoys a 4.5% or roughly 60 bps increase in their capital ratio.[3] We caution, however, that this estimate of capital savings is sensitive to the assumptions required in our model. In fact, identifying the drivers of capital savings proved the more interesting aspect of the research.

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[2] "Capital Windfall?" ABA Banking Journal, October 2008; and "Capital Arbitrage Across and Within the Various U.S. Regulatory Capital Regimes," RMA Journal, November 2008.

[3] This number drops to 4.2% for 2008Q2

First, gross income margin is easily the most important driver of capital impact. Because of the questionable operational risk formula, institutions with the highest quartile of gross income margin have median capital savings of 1.2%, compared to a median savings of 9.3% for those in the lowest quartile. For a variable with little or no bearing on risk, gross income margin surprisingly determines the distribution of capital savings among banks. This finding underscores the urgency around modifying the BIA.

Second, capital impact is extremely sensitive to the LTV distribution. The 2004 Survey of Consumer Finances provides a flawed estimate of LTV for a few reasons. First, the survey dates back to 2003 which, perhaps ironically, might now be of increasing relevance to current circumstance. But the more problematic feature of the data is an ability to precisely identify origination home value for existing mortgages. Our analysis assumes an industry-wide weighted-average first-lien risk-weight of 34%, but capital savings for the median bank disappear if this figure is even ten percentage points higher. Combined with the origination versus current property value issue we describe above, this serves to emphasize the importance of getting the residential mortgage rules right.

An equally important driver of capital savings is proportion of small ticket CRE and C&I that qualifies for "regulatory retail" treatment. We assume that all loans reported as under $1mm on the call report will qualify for the lower 75% risk-weight. This assumption might be incorrect for two reasons: a) individual loans of less that $1mm might be held by obligors with more than $1mm in aggregate exposure, and, b) some of these loans might not be held within "well diversified" portfolios. We assume the first issue is immaterial, but the latter depends critically upon regulatory treatment. Our analysis suggests that prospective capital savings are wiped out for a majority of banks if their small-ticket loans are not treated as regulatory retail. The agencies should be very judicious in their use and definition of the "well-diversified" criteria so as not to unduly diminish the adoption of the regime.

Potential Regulatory Capital Arbitrage Across and Within Capital Regimes. Our second line of work considered how the introduction of another regulatory capital regime might exacerbate possible capital arbitrage. Our paper identifies a number of ripe arbitrage opportunities, including:

1. Proliferation of special purpose entities to skirt the $1mm obligor limit for regulatory retail exposures.
2. Advanced banks swapping high-risk exposures to Standardized and General regime banks.
3. Unusual mortgage loan structuring to optimize LTV ratios just below the various Standardized risk-weight thresholds.

The larger theme that emerges is that riskier assets will tend to migrate from banks in the Advanced regime towards banks complying with the Standardized and General regimes. There is no easy solution to this imbalance, which is driven by disparities in risk-sensitivity across regime. To the extent that greater risk-sensitivity can be loaded into the Pillar Two examinations of *all* banks, regulators can more readily control the darker motives of banks intending to arbitrage the Pillar One rules.

Conclusion

Regulators should be commended on their effort to create a risk sensitive regulatory regime that also emphasizes prudent capital management. Upon implementation, these rules will immediately and significantly reward community and regional banks that have been judicious in their lending and deployment of investment capital. These stewards of capital and prudent risk management will be recognized by their peers and rewarded by the market, resulting in an industry movement toward enhanced capital management. This is certainly a needed prescription for an industry suffering from opaque risk management practices. Further, policy makers should appreciate the sensitivities we identify in our research. Ignoring these warnings will discourage adoption and undermine the value of the rule. It could also lead to exaggerated competitive issues between advanced and community banks, as well as domestic and foreign institutions. Without fair and reasonable Pillar One requirements, we fear that the promise of this regulation to help transform risk management will be compromised. ***Therefore, we implore policy makers to swiftly implement these changes and decouple Standardized implementation from Advanced adoption while being transparent, grounded, and judicious in any changes they suggest to the current proposal.***