June 29, 2005

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5
Washington, DC 20219
Re: Docket No. 05-08

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Re: Docket No. OP-1227

Robert E. Feldman
Executive Secretary
Attention: Comments
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: No. 2005-14

Dear Sir or Madam:

The Independent Community Bankers of America (ICBA)[1] welcomes the opportunity to comment on the proposal by the federal banking agencies on Classification of Commercial Credit Exposures that would modify the existing Commercial Loan

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[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 promoting the interests of the community banking industry. With nearly 5,000 members, ICBA members employ more than 225,000 Americans and hold more than $778 billion in total assets. For more information, visit ICBA's website at www.icba.org.*

Classification System. Banks and regulators use the current system to measure the level of credit risk in commercial loan portfolios, benchmark credit risk across institutions, assess the adequacy of a bank's capital and allowance for loans and lease losses, and evaluate an institution's ability to accurately identify and evaluate the level of credit risk posed by commercial exposures.

Summary of ICBA Position

Properly assessing credit risk is a key factor in maintaining the health of banks both large and small. While not perfect, the current commercial loan classification system, which with periodic revisions has been in place for close to 70 years, has served as an important risk assessment tool through a number of economic cycles. Community banks believe it works well in identifying and evaluating credit risk and provides reliable information for determining capital adequacy and the allowance for loan and lease losses. The proposal to change the classification system is very troubling to the majority of community bankers as they see the costs and burdens of the change far outweighing the benefits it would bring. Community banks are already disproportionately weighed down by regulatory burden and implementing this proposed classification framework would unnecessarily add to the load. Thus, ICBA urges the banking agencies not to go forward with it.

Background

The agencies state that the current classification system focuses primarily on borrower weaknesses and the possibility of loss without specifying how factors that mitigate the loss, such as collateral and guarantees, should be considered in the rating assignment. According to the agencies, this has led to differing applications of the current classification system by institutions and the agencies.

The banking agencies state that under the current classification system, rating differences between an institution and its supervisor commonly arise when, despite a borrower's well-defined credit weaknesses, risk mitigants such as collateral and the facility's structure reduce the institution's risk of incurring a loss. The current classification system does not adequately address how, when rating an asset, to reconcile the risk of the borrower's default with the estimated loss severity of the particular facility. As a result, the system dictates that transactions with significantly different levels of expected loss receive the same rating. The banking agencies believe that this limits the effectiveness of the current classification system in measuring an institution's credit risk exposure.

Consequently, the banking agencies are proposing a two-dimensional rating framework that considers a borrower's capacity to meet its debt obligations separately from the facility characteristics that influence loss severity. They believe that differentiating between the two factors would provide a more precise measure of an institution's level of credit risk.

ICBA Comments

A few community banks have told ICBA that the proposed new classification system is similar to what they are using now and do not see that adoption would be burdensome. These banks tend to be larger than the average size (by assets) of ICBA members.

INDEPENDENT COMMUNITY BANKERS of AMERICA The Nation's Voice for Community Banks℠
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However, the majority of community banks ICBA has discussed this proposal with have raised strong objections to it. These banks strongly object to the costs and burdens on of implementing a new classification methodology that they view as unnecessary. We believe that the agencies overstate the perceived deficiencies in the current system. The current classification system enables bankers and regulators to look beyond the borrower's capacity to meet its debt obligations and consider characteristics related to the facility, such as government guarantees and collateral values, that affect loss severity when classifying credits and setting the allowance. Community banks have told ICBA that they have worked very hard to conform to the current guidelines that have historically worked well. Their auditors, and state and federal examiners are generally in agreement that their loans are appropriately classified. A new classification framework would require retraining of staff (and examiners and auditors), development of new policies and loan review procedures, and changes to information systems and related internal controls. The majority of community bankers do not believe that the current system is in need of replacement and believe that the time and money that a change in classifications framework would require could be put to better use.

The current classification system by its nature requires judgment calls and therefore can result in differences of opinions between bankers and examiners. But the proposed system will also require some judgment calls that may well continue to result in differences in opinions between bankers and examiners. Thus there is no guarantee that the new classification system will clarify the process so as to eliminate all differences of opinion. During the implementation period, differences in opinion are likely to increase as bankers, their auditors and bank examiners learn the new system and how to use it.

For these reasons, ICBA urges the banking agencies not to go forward with the proposed new classification system for commercial credit exposures. If some institutions wish to implement a system like the one that is proposed, as some community banks have done, the regulators should permit it. Deficiencies in classification systems should be addressed on a bank-by-bank basis through the examination and supervision process, as is the case now. A more detailed classification system, such as the one proposed, may be useful for large, complex banks that don't have as direct contact with borrowers or industries as a community bank might. Banks that need a more complex framework for classifying credits should not be precluded from adopting one. But, the current system in ICBA's view is working well. We do not see the need for regulators to mandate a change in classification methods for the entire banking industry when the costs and burdens of making the change outweigh the benefits.

Thank you for the opportunity to comment. If you have any questions or need additional information, please contact the undersigned at 202-659-8111 or ann.grochala@icba.org.

Sincerely,

Ann M. Grochala

Ann M. Grochala
Director, Lending and Accounting Policy