Guaranty BANK

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Memorandum

TO: **Chief Counsel's Office**
Office Of Thrift Supervision

FROM: **Mike Calcote, Chief Financial Officer**

DATE: **November 3, 2003**

SUBJECT: **Advance Notice for Proposed Rulemaking on the Proposed Risk Based Capital Rules (Joint Advanced Proposed Rule No 2003-27)**

Guaranty Bank ("Guaranty") strongly concurs with the efforts by bank and thrift regulators to upgrade the regulatory capital framework. While the current framework (the "1988 Accord") has served the industry well, advances in risk management and financial engineering over the past 15 years mandate a more granular differentiation of risks, able to be customized to the unique risk profile of each institution.

In our judgment, there are two implicit themes woven into the new, proposed regulatory capital rules ("Basel II"):

a) The banking industry in the U.S. (and here we lump all commercial banks and thrifts together as "banks") is assumed to be fragmented, with the very large banks serving asset-side markets, providing products, and taking on risks that are <u>distinctly different</u> from the markets, products, and risks of other U.S. banks. There are at least three tiers, described in Basel II as "core," "opt-in," and "general."

b) Because the risks borne by banks are difficult to neatly compartmentalize, and any arbitrary system would quickly become obsolete or lead to capital arbitrage, Basel II shifts much of the responsibility for determining the appropriate capital allocation to the bank itself. Each bank will interpret this as either a "carrot" or a "stick," to incent a more thorough understanding of the risks it bears and how these risks evolve and interact.

We will make references to these themes in our commentary below, which will generally follow a format suggested by OTS Director Gilleran.

WOULD BASEL II CREATE PRICING ADVANTAGES FOR CERTAIN INSTITUTIONS ?

We believe Basel II, as proposed, would provide pricing advantages to certain institutions and a general disadvantage to our organization along with the thrift industry overall. While Basel II would not preclude any institution from "opting in," there are practical, economies-of-scale-related constraints which would have the effect of excluding most institutions. Yet many of these "general" institutions compete with "core" and "opt-in" institutions in various asset and deposit markets. Our major concern is with the mortgage markets. The Bank For International Settlements – sponsored quantitative impact studies ("QIS") suggest that "core" and "opt-in" banks will tend to have a much lower capital allocation to mortgage assets than is currently permitted under the 1988 Accord, the latter of which will continue to dictate the behavior of "general" institutions, including Guaranty, for at least the next few years.

The mortgage market investor base has become relatively highly concentrated over the past ten years, and mortgage valuation methods have found a reasonable consensus. To the extent that "core" and "opt-in" banks contribute to consensus pricing in the market (both the primary and secondary markets), Guaranty's relative, risk-adjusted returns would be expected to suffer. If the capital allocation to mortgage assets under the 1988 Accord is higher than it would be for "core" and "opt-in" banks under Basel II, then Guaranty, along with a preponderance of other thrift institutions, would be "priced out of the market" for mortgages. The proposal as drafted could result in the unintended consequence of institutions being pushed into riskier asset classes in order to generate acceptable returns (discussed further below).

WOULD BASEL II PROMOTE FURTHER INDUSTRY CONSOLIDATION ?

More generically, bank balance sheets would be expected to evolve as follows: "Core" and "opt-in" banks would migrate toward asset concentrations for which the 1988 Accord allocation is too high, and "general" banks would migrate toward asset concentrations for which the 1988 Accord allocation is too low (and this would include activities laden with operational risk). While Basel II proposes to reduce "capital arbitrage," this might hold true only at the individual bank level. On an industry wide basis, such arbitrage could still take place. However this would be a transitional state. Basel II is intended to encourage banks to allocate capital based on the intrinsic riskiness of assets and activities, in the context of their individual balance sheets, and as they evolve over time. "General" banks over-concentrated in activities in excess of their respective capital bases would receive an adverse reaction from stakeholders and regulators, which would lead ultimately to further industry consolidation.

Guaranty believes that a degree of fragmentation in the industry is desirable, from both a customer standpoint and a regulatory standpoint, even though the delivery of many products and the management of many internal processes benefit from economies of scale.

The "wild card" in the mortgage market right now is the future behavior of the mortgage-related GSEs – FannieMae, FreddieMac, and the Federal Home Loan Bank system. Widely anticipated regulatory reform may alter their involvement in the mortgage market, particularly as it relates to their capital requirements, "mission" objectives, and the markets' perception of their soundness. For example, GSEs which become more aggressive and more focused on "prime"-quality conforming mortgages might further "crowd out" bank (particularly thrift) involvement in this market. While the mortgage market has taken on a great deal of product and process standardization over the past 20 years, we believe there is still a need for customization and niche marketing, which are both better served by a fragmented industry model.

SHOULD A SINGLE, RISK-BASED SYSTEM BE DEVISED FOR ALL INSTITUTIONS ?

Guaranty does not endorse a common capital regime for all banks, as it would immediately become obsolete, since it would have to be suitable for all levels of sophistication in the industry (a "lowest common denominator" effect). We view the concept of a bifurcated capital allocation system, somewhat like the one being proposed, as an implicit incentive for banks to refine their risk management systems and to begin to manage risks holistically (a "carrot" perspective). But we think the current proposal is too severely dichotomous, given that "core," "opt-in," and "general" banks compete with each other in various markets. And because of its relative immaturity, the technology and infrastructure needed to manage such risks are more accessible for larger institutions that can take advantage of scale economies.

However Guaranty does recommend that the 1988 Accord be revisited and modified before it is imposed on "general" banks. If, for example, there is clear evidence (per the QIS, and it is the consensus of industry experts) mortgage assets tend to be over-allocated capital under the 1988 Accord, then perhaps the required capital allocation can be reduced, at least to a level which would still provide an incentive for banks to upgrade their risk management processes to a level of parity with core banks'.

We appreciate the opportunity to comment on the proposed change in regulations, and we would be happy to further elaborate on, or clarify, our position on the subject.

Sincerely,
Mike Calcote, Chief Financial Officer
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