Massachusetts Bankers Association

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November 3, 2003

regs.comments@ots.treas.gov
Office of Thrift Supervision
Chief Counsel's Office
1700 G Street, NW
Washington, DC 20552
Docket No. 2003-37

Regs.comments@federalreserve.gov
Jennifer Johnson
Docket No. R-1154
Board of Governors of the Federal Reserve Sys.
Mail Stop 155
20th Street and Constitution Avenue
Washington, DC 20551

Comments@FDIC.gov
Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Basel.Comments@occ.treas.gov
Docket No. 03-14
Office of the Comptroller of the Currency
Mail Stop 3-6
250 E Street, SW
Washington, DC 20219

Subject: Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord

To Whom It May Concern:

On behalf of the Massachusetts Bankers Association's 225 commercial, savings and co-operative banks and federal savings members located throughout Massachusetts and New England, we welcome the opportunity to comment on the Advance Notice of Proposed Rulemaking (ANPR) addressing the implementation in the United States of the new Basel Capital Accord (New Accord) being developed by the Basel Committee.

The Association supports the overall goal of Basel II, which is to create a measure of capital adequacy that better links capital requirements to the risk profile of large internationally active banks. The proposal is radically different from the 1988 Capital Accord in that the risk-based capital requirements would no longer be based on a few pre-set capital ratios but rather, banks would be permitted to set their own capital requirements by using a sophisticated internal system of defining risk estimates for each credit exposure. The intended effect would be to create risk sensitive minimum capital ratios and less opportunity for regulatory capital arbitrage.

The ANPR proposes to mandate compliance for the top 10-12 large, complex and internationally active institutions with total commercial bank assets of $250 billion or more or total on-balance sheet foreign exposure of $10 billion or more (core banks). Other institutions (opt-in banks) can voluntarily comply with the New Accord if they can meet all of the eligibility standards. If the New Accord were adopted in the United States, we would for the first time have a bifurcated regulatory capital framework.

The Association would like to express our serious concerns with respect to the competitive inequities posed by the proposed New Accord on our member banks, which for the most part are regional and community banks with a strong market presence in retail, business, and residential mortgage lending. The New Accord also has negative implications for banks specializing in fee-based lines of business, such as investment servicing and investment management which do not have a significant retail-banking component.

The New Accord has the potential to create competitive inequities for domestic core banks competing with opt-in banks; domestic core banks competing with non-bank institutions for similar products; and domestic banks competing globally with banks that have less restrictive regulatory oversight.

Domestic Competition

The cost and complexity of opting in to the New Accord does not make this a viable option for most regional and community banks since only a limited number of financial institutions will be able to make the substantial investments in systems and infrastructure needed to utilize the risk-sensitive capital framework.

While the ANPR would apply the Accord to the 10 largest institutions in the country, it foresees that the next 11 – 20 largest institutions could, for competitive reasons, voluntarily choose to comply with the Accord's requirements as well. Our major concern, however, is the unintended consequences that provide the top few banks a significant competitive advantage – through lower capital requirements. The New Accord could provide significant capital savings for institutions that focus on mortgage and other retail lending. Banks that do not opt-in to the New Accord could end up holding higher capital under the existing capital requirements for similar products.

As FDIC Chairman Donald Powell testified in a Congressional Hearing, "differences in minimum regulatory capital requirements for similar activities between the largest banks and other banks could, conceivably, affect which banks make and hold loans and how they are priced." For example, if a bank can verify a lower risk weight and justify only 15-25 b.p. capital for its residential mortgage portfolio, there is no question that it will have a major pricing advantage over its Basel I competitors retaining 400 b.p. capital for residential loans. Our members may find it more difficult to compete for quality assets.

Even more disconcerting is the potential "purchasing power" it provides to institutions that can deploy capital more efficiently under the New Accord. The Association is concerned that regional banks and smaller institutions which focus on residential lending may become acquisition targets of Basel II banks. For example, a bank under Basel II would be able to bid for competitors with sizeable retail portfolios, and even pay a premium to consummate the deal. This can occur because, once the merger is complete, the acquired loan portfolio only requires 15-25 b.p. capital, in our example, and not the 400 b.p. required for the recently acquired residential lending bank. While consolidation in the banking industry is expected to continue for the foreseeable future, the proposed New Accord cannot be implemented in the U.S. without eliminating the strong competitive presence of local regional and community bank lenders.

Our concern is not only for the regional and community banks that will suffer but also for their customers and the community they serve. If a Basel II bank wants to "own" a market, the Accord provides the tools to undermine any financial institution it chooses in any community through either its anti-competitive pricing advantage or by simply buying out the competition.

We believe the New Accord to be inherently unfair in this regard and would strongly urge the federal banking agencies to "re-think" this issue before implementing any aspect of the proposal.

Non-Bank Competition

The New Accord also raises competitive inequity issues among Basel II banks and non-banks. U.S. banks compete directly with other non-bank financial institutions (i.e. investment management firms, broker/dealers, insurance companies, mutual funds, etc.) that are not covered by the proposed "mandatory" capital requirements. While the New Accord may lead to reduced credit risk capital requirements for certain asset classes, institutions will be subject to an explicit charge for operational risk. Specialized investment banks without retail operations will not benefit from the lower capital requirements of credit risks to offset the increased operational risk requirement. For such banks, the operational risk requirement in the New Accord creates an uneven playing field that can be exploited by

non-bank competitors as well as banks not subject to the Basel II requirements. Despite efforts to create a flexible approach to operational risk, the proposal is complicated and untested.

International Application

The New Accord raises serious concerns for internationally active banks that compete globally in jurisdictions that operate in a less restrictive regulatory scheme. Regulators will have considerable discretion in how to apply the new rules in their respective countries. There is a high potential that overseas banks will have a competitive advantage over U.S. Basel II banks that must adhere to a stricter regulatory environment from an enforcement standpoint than their foreign counterparts. In addition, international banks operating in multiple jurisdictions may be challenged to have a consistent method for measuring risk and consistent policies for the management of risk across the firm.

Conclusion

The New Accord should not be implemented in the United States until there is a better understanding of its ramifications in the U.S. markets. It is not clear whether the incremental benefits of lowering capital requirements will justify the increased cost. We understand that U.S. banking supervisors are undertaking an interagency pilot program that will help to prepare for the implementation of Basel II. However, we suggest that the regulators also review and consider alternative approaches that do not represent such a radical departure from the existing regulatory capital framework.

While there may be a need to adjust existing capital requirements, the proposed New Accord needs significant modifications before adoption in the U.S. Banks have expressed that the New Accord proposes a highly complex, onerous and costly approach to determining risk. For example, there are 80 separate requirements that must be met in order for a bank to use the advanced internal ratings-based approach to credit risk. Separately, one of our members has commented that the rules do not properly distinguish risk profiles associated with the different roles a financial institution may play in the securitization market.

The U.S. banking regulators should work with the industry to develop a more streamlined and less complicated approach to risk-based capital. Additionally, the agencies should remove the requirement that an institution adopt the internal ratings-based approach for credit risk and the advanced measurement approach for operational risk at the same time.

On behalf of the membership of the Massachusetts Bankers Association, I thank you for your consideration of our views. In the meantime, please call me or Tanya Duncan, Director of Federal and Housing Policy, at the Association office.

Sincerely,

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President

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