October 22, 2012

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W. Washington, D.C. 20551
regs.comments@federalreserve.gov
Docket R-1430 and R-1442; RIN No. 7100-AD 87

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219
regs.comments@occ.treas.gov
Docket ID OCC-2012-0008 and OCC-2012-0009; RIN 1557-AD46

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation,
550 17th Street, N.W.
Washington, D.C. 20429comments@fdic.gov
RIN 3064-AD95 and RIN 3064-AD96

Re: Basel III Capital Proposals

Dear Sirs and Madam:

On behalf of our 185 commercial, savings, cooperative banks and savings and loan associations located throughout the Commonwealth and New England, the Massachusetts Bankers Association (MBA) appreciates the opportunity to provide our comments on the Basel III proposals (the "Proposals") entitled: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions; Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule. As you know, these proposed rules were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

General Comments

MBA strongly believes that the Proposals are far-reaching and needlessly complex and, if adopted, will have a wide range of negative implications on consumers, small businesses and the banking industry. In addition to being extraordinarily complex and presenting numerous operational and compliance challenges to the industry, the Proposals remove regulatory discretion and expertise from the safety and soundness examination process. US banking regulators already have broad authority to impose bank-specific capital requirements on depository institutions through the existing prompt corrective action process and have far greater knowledge of local and regional economic conditions on which to base their

regulatory decisions. We recommend placing more emphasis on principled and qualitative measures of risk as monitored by bank management and experienced regulators instead of a punitive, one-size-fits-all model that applies to both the largest, most complex institutions in the world, as well as local community institutions with generally conservative balance sheets that pose little risk to the global economy.

MBA and our member institutions support a banking system with robust capital levels. The vast majority of our member institutions are capitalized well above regulatory minimums and maintained strong capital levels throughout the recent financial crisis. Strengthening the level and quality of capital throughout the industry both in the United States and abroad are important goals as regulatory agencies address the aftermath of the crisis.

Our member institutions have relatively simple and conservative balance sheets and did not engage in the risky lending and investment practices that caused the financial crisis. More than 70 percent of our member banks are mutual institutions, many of which have been in business for more than 150 years serving their local communities. These institutions generally do not utilize complex derivatives or engage in substantial off-balance sheet transactions – they are traditional residential and commercial lenders regulated by both state and federal regulatory agencies.

The banking industry in Massachusetts and throughout New England weathered the recent economic downturn far better than many other regions, with delinquency rates in Q2 significantly lower than the national average (1.24% vs. 3.89%) and only one bank failure in the six New England states since 1993. In fact, our member banks increased their lending capacity to offset the pullback by many of the non-bank lenders and large national institutions during the recession.

It appears that there is a needless urgency at the regulatory agencies to finalize and implement the Proposals as quickly as possible – without a comprehensive study of the broad impact they will have on the industry. For example, while the proposals have been available since July, an estimation tool was only recently made available. Therefore, MBA strongly believes the Proposals should be withdrawn in order to take more time to study the potential impact and that the regulatory agencies should then analyze those impacts under a variety of market circumstances, such as an increase in interest rates.

If the agencies decide to move forward with the Proposals, MBA recommends that the final rules should exempt community and regional banks. As we will detail below, the Proposals will impose significant new regulatory and financial burdens on local banks and ultimately hurt the small businesses and consumers these institutions serve in their local communities.

Basel III: Risk Based and Leveraged Capital Requirements

- **Increases in Regulatory Capital**

As we stated above, MBA supports a banking system with robust capital levels and recognizes that regulatory expectations for minimum capital levels have changed in the wake of the financial crisis. While the vast majority of our members continue to hold capital in excess of regulatory minimums, we do believe additional analysis should be undertaken before raising capital levels throughout the industry. In particular, the complexity of the proposed risk-weighting rules, which will have a significant impact on our member banks, precludes the regulators from obtaining accurate data on the industry through the current call reports. A more thorough data collection project should be undertaken in this area if

policymakers are to truly understand the affect the proposed risk-weighting rules will have on the industry and the overall economy.

- **Capital Conservation Buffer**

MBA believes the agencies should eliminate the proposed "capital conservation buffer" along with the restrictions on dividend distributions and executive compensation. As we stated earlier, we believe the existing regulatory framework adequately addresses these concerns in a more appropriate fashion.

The regulatory agencies already have substantial authority to impose restrictions on dividends or compensation at institutions facing financial difficulties. We strongly believe that this authority provides adequate safeguards against the payment of dividends when circumstances are not appropriate.
We believe that it is appropriate to leave decisions regarding restrictions on the payment of executive compensation and capital distributions to the discretion of the regulatory authorities on a case-by-case basis as opposed to a one-size-fits-all formula.

- **Inclusion of AOCI in Calculating Tier 1 Capital**

The proposed rule mandates that banks include Accumulated Other Comprehensive Income (AOCI) in calculating Tier 1 capital. The primary driver of AOCI (or loss) for most institutions is unrealized gains and losses in the available-for-sale securities portfolio. The inclusion of unrealized gains and losses on these securities in determining Tier 1 capital has the potential to substantially increase the volatility of Tier 1 capital and artificially distort the bank's regulatory capital ratios, particularly during periods of rising and falling interest rates. This mark-to-market accounting for some assets without similar accounting treatment for liabilities does not seem to be a consistent methodology.

Community banks holding interest rate sensitive securities for sound business purposes could see changes to their capital ratios based solely on interest rate changes rather than changes from credit quality. In Massachusetts and New England, many of our traditional, state-chartered bank members have investment powers that have existed in some cases as far back as the 1800s. In fact, we would assert that more than 100 banks in the northeast would not have survived the disintermediation of the late 1970s and the asset/liability mismatch problems of the early 1980s were it not for their sizable portfolio gains. These activities were re-affirmed as a safe and sound practice in Section 24 of the Federal Deposit Insurance Act (FDIA) in 1991 and, based on their proven track record, expanded to other Federal Deposit Insurance Corporation-regulated banks in subsequent years.

Specifically, Section 24 permits certain insured state banks to make limited investments in equity securities on a registered exchange that would not otherwise be permissible. The institutions exercising these powers do so under well-established state and federal guidelines and qualifying banks have used their subsection (f) investment powers prudently over many years. No one has suggested that these limited investment powers contributed to the recent financial crisis. On the contrary, we strongly believe that the portfolio gains and dividend income derived from these investments provide a dependable source of capital for balance sheet restructuring, dividend income, increased loan loss reserves and community investment activities. Institutions that use their investment powers generally hold securities for long-term gains, not short-term profits, providing a source of strength and stability that has enabled these institutions to weather uncertain economic conditions.

Further exacerbating AOCI problems is the exclusion of all investments (debt or equity) above 10 percent of capital in other financial institutions. This requirement would needlessly raise the cost of investing in other financial firms, about which banks should be most familiar. Adoption of this provision would have several effects on institutions holding bond and equity portfolios, including forcing banks to avoid market changes by shortening the maturity of their portfolio, resulting in lower yields and earnings and reclassifying bonds from "available for sale" to "held to maturity", lessening the ability of an institution to effectively manage their bond portfolio.

In addition, the proposed risk rating of 300 percent on all equity securities is extraordinarily punitive, since these institutions invest primarily in safer Fortune 100 dividend producing stocks or index mutual funds. Arbitrarily including an entire asset class into one risk weighting category is neither reasonable nor consistent, since the equities market is diverse and has a wide-ranging level of risk. Investment in a blue-chip income stock is far different than investing in penny stocks or volatile Initial Public Offerings. Since debt securities have a range or risk weighting, a similar system for risk weighting equities should be considered.

While larger institutions may hedge the impact of interest rate changes on AOCI, community banks are unable to do so and in a rising interest rate environment, including unrealized gains and losses in determining capital would negatively impact the ability of banks to contribute to economic recovery. The final rule should allow institutions to continue to exclude AOCI from capital measures as they are currently required to do today.

- **Phase out of Trust Preferred Securities as Capital Instruments**

The proposed Basel III capital rule does not grandfather Trust Preferred Securities for institutions between $500 million and $15 billion, which is inconsistent with the Congressional compromise language regarding the Collins amendment that was incorporated into the Dodd-Frank Act. Instead, the proposal requires the phase-out of these instruments for bank holding companies having between $500 million and $15 billion with annual 10% decreases in the includible amount through 2021, until the instruments are fully phased-out on January 1, 2022.

MBA opposes the proposed requirement to phase-out Trust Preferred Securities and other restricted core capital elements. We believe that the legislative intent expressed in the adoption of the DFA should be respected. This provision was subject to substantial debate during the legislative process and lawmakers determined that the final compromise language providing a complete exemption for smaller institutions was the correct policy decision

As we stated above, more than 70 percent of our membership consists of mutual institutions. This provision is especially harmful to mutual institutions and other privately-held banks, which have few options for raising capital. A significant number of these institutions have relied on trust preferred securities to raise capital, since mutual banks by definition cannot issue common stock. Adopting a regulation in direct opposition to the intent of Congress would further diminish avenues to raise capital and many banks would be forced to shrink their balance sheets by reducing lending in their local communities and reducing the amount of credit available to small businesses and consumers. The proposed rule should be revised to fully recognize the intent of the Collins amendment by permanently grandfathering outstanding Trust Preferred Securities for institutions between $500 million and $15 billion.

- **Limitation on Inclusion of Allowance for Loan and Lease Losses in Regulatory Capital**

There are various provisions in the Proposals that would force institutions to "double-count" risk elements on bank balance sheets. MBA believes that if these provisions are adopted, the final rule should also eliminate the current arbitrary regulatory limitation on the amount of an institution's Allowance for Loan and Lease Losses (ALLL) that is includable in its capital, which is currently set at the amount equal to 1.25% of total risk-weighted assets. Banks should be encouraged to build reserves during good economic times and removing this restriction would encourage institutions to fund their ALLL.

- **Limitation on Value of Mortgage Servicing Assets**

Under the proposed rule, institutions are required to deduct all mortgage servicing assets (net of deferred tax liabilities) that exceed 10% of its common equity Tier 1. In addition, the amount that is below the 10% threshold will receive a 100% risk weight, increasing to 250% beginning in 2018. Current rules already impose a 10% haircut on the fair market value of readily marketable mortgage servicing assets that are included in regulatory capital. Imposing this new requirement will even further impact U.S. banks beyond the current 10% requirement.

Many of our member institutions of all sizes sell mortgage loans they originate to third parties while retaining the right to service the loan. This practice is particularly prevalent in the current interest rate environment, where banks are unable to hold substantial amounts of fixed-rate mortgages on their balance sheets because of the inherent interest rate risk. Retaining the servicing of these loans provides the bank with a future income stream as well as a continued interface with the borrower. Some of our members have made loan servicing a specialty, with mortgage servicing assets oftentimes exceeding 10 percent.

The deduction of mortgage servicing assets combined with the punitive risk weight could severely impact some community banks, perhaps even lowering their capital levels below well capitalized status. Based on this proposed capital treatment, some banks may choose to exit the mortgage servicing business impacting long standing customer relationships and reducing fee income. In effect, this turns the mortgage business over to the very non-bank lenders that created the crisis and are <u>not</u> subject to these new capital standards.

It is our understanding that not only will this apply to residential mortgage servicing assets, but banks that participate in lending programs through the Small Business Administration (SBA) will also be affected. Community banks that sell the guaranteed portion of their SBA loans for liquidity and profitability reasons are required to hold a Servicing Asset of at least 1.00% of the guaranteed portion and they are required to service the loan for the life of the loan. This SBA Servicing Asset is considered an MSA under the proposal and a portion of that amount must be deducted from Tier 1 capital.

In addition, for underlying loans that are less than 50 percent secured by real estate, the entire MSA must be deducted from Tier 1. If applied retroactively, this would create a significant operational burden, since banks would need to determine the deduction on a loan by loan basis. Any change in this area could discourage institutions from originating SBA loans at a time when policymakers are encouraging banks to do more small business lending.

MBA believes that the final rule should not include any deduction from capital for mortgage servicing rights. If the regulatory agencies decide to move forward with any changes to the capital rules in this area however, any existing mortgage servicing assets should at the very least be grandfathered. It is unfair to

penalize banks with long standing mortgage servicing assets as a result of the Basel Committee's Eurocentric model which has few community banks and residential lenders. In addition, the agencies should allow banks to include 100% of the fair market value of readily marketable mortgage servicing assets to reduce the impact of the proposal.

- **Minimum Pension Liability Adjustment**

The Proposals also require banks to include their minimum pension liability adjustment for GAAP purposes in regulatory capital. The minimum pension liability adjustment in equity can be extremely volatile, since it depends on a number of assumptions and actuarial calculations. Many community banks have pension plans that require this equity adjustment for accounting purposes; however these adjustments are non-cash temporary items that can go from a loss to a gain within a year.

Many of our member institutions pension plans are currently underfunded for one reason: the historically low interest rate environment. It would be unreasonable to expect banks to shrink their balance sheets to meet minimum capital ratios because of this temporary pension adjustment – by the time the balance sheet restructuring was put in place, the unrealized loss could turn that quickly into a gain as interest rates normalize.

- **Small Savings and Loan Holding Companies**

Under the Federal Reserve's Small Bank Holding Company Policy Statement, it is our understanding that the Basel III Proposal generally would not apply to bank holding companies with total consolidated assets of less than $500 million. MBA believes the agencies should consider the following issues prior to the adoption of any final rule.

First, because the Policy Statement does not cover small savings and loan holding companies (SLHC), there is no similar exemption for SLHCs with less than $500 million of total consolidated assets. Smaller savings and loan holding companies face the same challenges that smaller bank holding companies do with respect to raising capital. They generally do not have access to public equity markets and therefore need to rely on alternative sources of capital, such as debt. Further, because these companies have not previously been subject to consolidated capital requirements, many of them do not presently have capital structures that would allow them to comply with the requirements of the Proposal. Therefore, if the agencies decide not to exempt smaller institutions entirely from the Basel III regulations, we recommend exempting SLHCs with less than $500 million in total consolidated assets.

In addition, if the agencies do not adopt a broader exemption, MBA supports an increase in the asset threshold for small bank and savings and loan holding companies to at least $10 billion. We believe this more accurately reflects the current industry profile and would provide additional relief for many smaller holding companies.

Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements

- **Substantial Increase in the Risk Weighted Asset Amount for Residential Mortgages**

The regulators are proposing new methodologies for risk weighting mortgages that are heavily dependent on data and will likely result in a substantial increase in risk weights – in some cases up to 200 percent. These new risk-weight formulas apply to both new mortgages as well as existing loans that are

currently in banks' portfolios that were underwritten to comply with existing capital standards. Since Massachusetts and New England are home to a large number of banks that specialize in residential lending, the proposed risk weights will have a disproportionate impact on a significant number of our member institutions.

The proposed rules rely heavily on loan-to-value (LTV) measures and appraisals in determining the risk-weighting for residential mortgage exposures. Under the proposal, only the highest quality mortgage loans with low loan-to-value ratios and strongest credit characteristics will qualify for the lowest risk weighting (Category I). Many other well-underwritten loans will now be subject to sometimes substantially higher risk-weightings, with loans in Category 2 with LTVs higher than 90 percent subject to a 200 percent risk-weighting – double the risk-weight for unsecured consumer loans.

It is unclear how the regulators can propose that any category of residential mortgage loans, which are secured by real property, could present twice as much risk to a bank than an unsecured consumer loan. MBA believes that the highest risk-weighting that should be applied to a residential mortgage exposure is 100%.

The proposal significantly increases capital costs for portfolio lenders, and disadvantages insured banks compared to non-bank mortgage lenders and credit unions that are not subject to these requirements. In particular, we believe these new capital requirements will have a chilling effect on the availability of credit to first-time homebuyers and low-and moderate-income borrowers with less than perfect credit histories. Banks that had previously placed loans to these populations that did not fit the secondary market guidelines in their portfolios will be forced to curtail this type of lending in the future or increase the costs of providing credit to these borrowers. Perversely, this will enable the same unregulated and lightly-regulated entities that helped precipitate the mortgage crisis to re-enter the market and attract borrowers who may not be able to obtain a mortgage from a well-regulated local bank.

For example, for well underwritten, fully documented first mortgages, with no balloon payments, no negative amortization, and with prescribed interest rate caps if the loan is an ARM, the capital risk weight will increase from 50% to 75% if the LTV ratio is above 80% and the risk weight will increase to 100% if the LTV is above 90%. Therefore the current capital charge will double on a loan made to a first time home buyer who puts 5% down in cash and has mortgage insurance to cover the rest of the loan, since under the Proposal, mortgage insurance will no longer be considered when determining the loan-to-value ratio. This will also adversely affect minorities and other disadvantaged consumers who have difficulty making large down payments, particularly in a high-cost state such as Massachusetts.

For second liens, home equity lines of credit, and first mortgages that do not meet the requirements noted above (for example because the loan has a balloon feature), the risk weight for the loan will increase even more dramatically. For example, the risk weight for a home equity line would be 200% if the combined LTV (based on the amount of the first loan plus the total amount of the line, whether drawn or not) exceeds 90%.

A number of our member banks have already indicated that increasing the risk-weighting for residential mortgages will force them to reevaluate their participation in the market. If these institutions decide to curtail or eliminate this type of lending, consumers will have fewer choices in the marketplace and the cost of credit, particularly to low- and moderate-income populations unable to afford a 20 percent down payment, will increase.

With the ongoing rulemakings regarding the definition of Qualified Mortgage (QM) and Qualified Residential Mortgage (QRM), MBA strongly urges the agencies to wait to finalize these provisions of the rule until final QM and QRM rules are issued. In addition, the Consumer Financial Protection Bureau (CFPB) has a number of open rulemaking proceedings that will have a significant impact on the mortgage process. Further study and coordination of rulemaking activities in this area are essential to ensuring that banks are not faced with conflicting requirements from the consumer protection and safety and soundness regulations.

As we have detailed above, the proposed risk-weighting of residential mortgage exposures is the most problematic change in the Proposals for the vast majority of our member banks. MBA believes the proposed changes could have a tremendously negative impact on consumers and that the proposed risk weightings are inappropriate with their reliance on LTV ratios. While the Standardized Approach Proposal refers to various types of residential mortgage loan products that were problematic during the recent financial crisis, including loans that were not properly underwritten, pay-option adjustable rate mortgages, and subprime mortgages, our member banks never engaged in this type of lending and should not be penalized in the capital rules going forward. We believe the implementation of changes to the risk-weighting of residential mortgage exposures should be eliminated.

At a minimum, any final rule should grandfather all existing mortgage exposures by assigning them risk weights as required under the current general risk-based capital requirements. Grandfathering such mortgages is appropriate, since aggregating and analyzing the data to calculate the risk weights will be extremely burdensome, particularly for existing loans or in cases where the institution merged or purchased another bank.

Additionally, given the substantial increase in capital that would be required for such existing category 2 mortgages, which may constitute a substantial amount of assets on an institution's balance sheet, the retroactive impact of the proposed treatment would be especially punitive. Given that the Basel III NPR is already substantially increasing required minimum capital, the need for retroactive application of the new standards is significantly attenuated.

- **Risk-Weighting of Past Due Exposures**

MBA is also concerned that the risk-weighting of past due exposures in the Standardized Approach Proposal ignores the existing processes by which financial institutions account for past due exposures and is redundant. The Proposal requires banking organizations to apply a 150% risk-weighting to assets that are 90 days or more past due or on nonaccrual status to the extent that those assets are not secured or guaranteed.

Delinquent loans must already be accounted for in an institution's ALLL analysis and banks are already highly regulated in this area. The agencies have been aggressive in criticizing banks that do not recognize the need for additional capital to mitigate potential losses. In addition, banks of all sizes are under significant regulatory and legislative pressure to work with delinquent borrowers and modify loans, particularly residential loans. Unfortunately, the Proposal will discourage institutions from keeping delinquent assets on their balance sheets, therefore reducing the possibility that a successful modification can be achieved.

Given that accounting framework, we believe that adding to the risk-weighting of past due assets constitutes unnecessary double-counting of the risk of the assets. MBA believes that existing accounting rules address this issue of risk sufficiently and this proposal should be eliminated from the final rule.

- **Credit Enhancing Representations**

Under the proposal, if a bank provides a credit enhancing representation or warranty on assets it sold or otherwise transferred to third parties, including in cases of early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100 percent credit conversion factor to the transferred loans while credit-enhancing representations and warranties are in place. Under the current general risk-based capital framework, risk based capital charges do not apply to mortgages once they are sold to third parties, even where the seller provides representations and warranties to take back mortgages that experience very early payment defaults (*i.e.,* within 120 days of sale of the mortgages).

The proposed change would result in substantial additional capital charges for a significant volume of sold mortgages, even though there is little evidence that the temporary representations and warranties associated with "pipeline mortgages" have resulted in significant losses for banks, even during the financial crisis. As a result, MBA opposes this provision and recommends that the agencies retain the 120 day safe harbor.

Conclusion

As we stated in the comments above, MBA believes that the Proposals have a variety of fundamental problems and that they should be withdrawn. The Proposals require substantial modification, and we believe additional studies are required in order to develop the most appropriate modifications to the capital framework.

We question whether the agencies fully understand the impact of the Proposals on the industry and the nation's economy. Many of the data points required to conduct a thorough analysis are not available on the current Call Reports and it does not appear the agencies conducted any data collection or industry-wide analysis prior to issuing the Proposals. Although many aspects of the Proposals are phased-in over a number of years, there is still a significant risk in finalizing sweeping changes to bank capital standards. Once finalized, there will be little opportunity to revise the rules after their impact is more broadly understood.

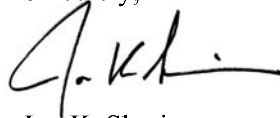
As we stated above, if finalized in their current form, the Proposals will result in a substantial withdrawal of banks, particularly community banks, from a variety of lines of business, including residential lending and providing credit for small business borrowers. Ultimately this loss of income and asset diversity will lead to an accelerated consolidation of local community banks throughout the United States while at the same time, policymakers in Washington, DC and at the state and local levels are calling on the banking industry to increase lending in these sectors. Consumer and businesses will be forced to obtain credit from non-bank lenders not subject to the new capital requirements – the same types of lenders that engaged in risky lending practices that helped precipitate the financial crisis.

Additionally, from a competitive standpoint, banks will be forced to comply with these new requirements while some of their largest competitors, the credit union industry, will be exempt. This exemption, in conjunction with the credit union industry's tax exemption, will further enhance their

competitive advantage over the community banking industry. If finalized, the Proposals should apply to all US depository institutions to ensure a level playing field.

Thank you again for the opportunity to comment on the Proposals. We respectfully ask that you consider our recommendations before developing final rules. If you have any questions or need additional information, please contact me at (617) 523-7595 or jskarin@massbankers.org.

Sincerely,



Jon K. Skarin
Senior Vice President