TESTIMONY OF

GREG GONZALES

COMMISSIONER OF FINANCIAL INSTITUTIONS

TENNESSEE DEPARTMENT OF FINANCIAL INSTITUTIONS

On behalf of the

CONFERENCE OF STATE BANK SUPERVISORS

On

"EXAMINING THE IMPACT OF PROPOSED RULES TO IMPLEMENT BASEL III CAPITAL STANDARDS"

Before the

FINANCIAL INSTITUTIONS AND CONSUMER CREDIT SUBCOMMITTEE

INSURANCE, HOUSING, AND COMMUNITY OPPORTUNITY SUBCOMMITTEE

COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

Thursday, November 29, 2012, 10:00 a.m.

Room 2128 Rayburn House Office Building

Introduction

Good morning, Chairman Capito, Chairman Biggert, Ranking Member Maloney, Ranking Member Gutierrez, and distinguished Members of the Subcommittees. My name is Greg Gonzales, and I serve as the Commissioner of Financial Institutions for the State of Tennessee. I am also the Chairman of the Conference of State Bank Supervisors (CSBS). It is my pleasure to testify before you today on behalf of CSBS.

CSBS is the nationwide organization of banking regulators from all 50 states, the District of Columbia, Guam, Puerto Rico, and the U.S. Virgin Islands. State banking regulators supervise, in cooperation with the Federal Deposit Insurance Corporation or the Federal Reserve, approximately 5,400 state-chartered insured depository institutions. Further, most state banking departments also regulate a variety of non-bank financial services providers, including mortgage lenders. For more than a century, CSBS has given state supervisors a national forum to coordinate supervision of their regulated entities and to develop regulatory policy. CSBS also provides training to state banking and financial regulators and represents its members before Congress and the federal financial regulatory agencies.

Today's hearing focuses on one of the most significant public policy matters facing the banking industry. The Basel III and Standardized Approach proposals would introduce sweeping changes to the regulatory capital framework and would significantly impact banks' credit allocation decisions and tolerance for risk. These proposals have emerged in a period when industry participants and policymakers alike are attempting to restore stability to the U.S. economic system and foster job growth. This also occurs at a time when many smaller institutions are expressing concern about regulatory burden and the impact regulation may be having on their long-term viability. As I will discuss more thoroughly, I believe it is in the best interest of the financial industry and the broader economy for the federal banking agencies to consider significant revisions to the proposals.

We appreciate the agencies' outreach to facilitate the industry's understanding of the capital proposals. They have gone to great lengths to deliver the facts of the proposals to the public. Their efforts have included hosting webinars, roundtables, and developing a calculator for banks to get a sense of their position within the context of the proposals. Indeed, I believe one of the main reasons for the volume of comment letters is due to their outreach. I have never seen a public policy matter to which the industry and other relevant stakeholders have been so well-informed and so well-versed. The educational aspect of the process has created a healthy and thorough dialogue on the proposals.

To be clear, we absolutely support enhancing the quality of capital and increasing required minimum capital. State bank regulators believe the agencies should pursue this effort outside of the Basel III process. But I also believe the issue at hand presents an opportunity for all of us to thoroughly evaluate our methods for developing meaningful and effective public policy to support our regulatory and economic goals. I am certain the lawmakers, federal regulators, and state bank regulators here today share the collective goal of supporting the effort to strengthen our financial system and generate stability for the American people. This is the fundamental concept that will frame my comments and suggestions.

Effective and Forward-looking Capital Regulation Requires a Balanced and Realistic Approach

The proposed capital rules are a symptom of a much bigger problem. Banking rules are increasingly being written with greater complexity and placing more burden on institutions. Federal policy, by its nature, tends to cover the entire industry with limited differentiation. The banking system is very diverse with over 7,200 banks ranging in size from a few million dollars in assets to well over one trillion dollars. Over 6,500 of these banks have assets under one billion dollars. Federal banking policy often applies to the whole industry, even if it is aimed at addressing issues particular to the largest, most complex institutions. As a result, these policies are increasingly inconsistent with how most banks conduct their business. Bankers are concerned they are losing their flexibility to exercise judgment which is critical to how a community bank functions. For most institutions, capital adequacy and risk management are not quantitatively or model driven. The management of risk for community banks is largely based on a thorough understanding of the underlying credit risk, a deep knowledge of its customer base, and an alignment between the success of the bank and its customers. State bank regulators fundamentally believe this is a model that must be maintained for our collective economic benefit.

We are concerned that regulatory policy is driving the industry to be too conservative. Leading up to the financial crisis, some institutions were over-extended in their risk tolerance in certain asset classes. This was matched by a regulatory environment which misjudged the bank's ability to manage risk and absorb losses. However, state bank regulators do not believe that the answer to every problem should be more capital. We must learn from these mistakes and expect more from banks in terms of risk management and improved supervisory processes. These are more difficult tasks, but I believe we have done this and can do more. The rules as proposed will do little more than limit credit to the most conservative exposures.

We need rules that ensure safety and soundness but permit banks to achieve economic success. It is important for us to remember that while 463 banks have failed in this cycle, over 7,000 banks survived. In addition, the resolution regime established by Congress and funded by the industry through the FDIC worked exactly as designed for all but our largest banks. The objective of our system-wide regulatory apparatus should not be to prevent all bank failures. Banks need to take prudent risks to serve their communities. When they make mistakes or when the economy moves against their exposures, we need to have confidence in a system that tailors a specific regulatory response according to the circumstances, while minimizing the economic and consumer impact. Banks must have the possibility of failure to have the opportunity for success.

The Proposed Rules Have Consequences for Economic Recovery and Job Growth

These proposals are fundamentally about economic development and job growth. Banks, all models and sizes, are a critical component of our economic engine. In particular, community banks are the primary drivers of local economic activity and small business job growth. CSBS is deeply concerned that the proposed capital framework will hamper banks' ability to take prudent risks in a period when general economic activity is minimal. In this sense, the proposals run counter to our efforts to restore the economy and foster job creation. We need

to seek policies that will encourage economic recovery in a prudent fashion, not policies that will further suppress the flow of credit or drive business from the regulated and insured depository system. Regulatory policy, both state and federal, has very local and very real economic consequences. When community banks are challenged, the communities they serve are challenged, as well.

We do not believe there is a sufficient understanding of the impact these proposals would have on the industry and credit availability. The agencies have published little analysis of the economic impact of these proposed rules, a step we believe is imperative before adopting such consequential measures. This lack of analysis bolsters uncertainty in the market and contributes to general business hesitancy. Four business days before the comment deadline for the proposals, the FDIC published for comment its statutorily mandated analysis of the impact the Standardized Approach proposal would have on banks with assets less than $175 million. The OCC and FRB have not yet published their analyses. The FDIC's conclusion, which finds that the Standardized Approach proposal will in fact have a significant economic impact on a large number of small entities, is troubling. It is important to note that this analysis was only performed for those institutions below $175 million in assets. The same type of analysis, if applied to the rest of the industry, may yield more striking results.[1]

Through the comment solicitation process, banks and other commenters have provided good examples of how the proposals will negatively impact traditional business lines that are fundamental to banks' operations and important to economic growth. We need to clearly understand how the proposals will change the type of credit available, the manner in which a bank lends, and the economic impact.

The Capital Rules Must be Part of a Targeted and Forward-Looking Regulatory Regime

Beyond the need to appropriately assess the proposals' impact on economic recovery and job growth, I strongly believe the proposals present an opportunity for us to critically evaluate our policy development approach. The industry has been very vocal about its concerns regarding regulatory burden. In our own experience, this is relatively easy to understand, but difficult to address. There is an opportunity for the industry and policymakers to discuss a prudent "right-sizing" of regulatory expectations. Furthermore, we can do much to address these concerns by carefully evaluating current proposals through the lens of regulatory burden and the appropriateness of regulation for the wide variety of institutions that operate within the U.S. The Basel III and Standardized Approach proposals are perfect examples of policy matters that we need to get correct immediately. We must take a long-term view of the industry and offer appropriate flexibility to accommodate the diversity of our financial system and the dynamic nature of the U.S. economy.

There are legitimate concerns about the complexity of the proposals, especially the Standardized Approach. I fully recognize that particular aspects of today's financial services industry present complex issues which must be addressed. However, not all transactions are complex and need a complex solution. Most of traditional banking follows the fundamentals: character, repayment ability, and collateral protection. If we want to effectuate change, it should

[1] Exhibit A: CSBS comment letter on FDIC's Regulatory Flexibility Analysis for the Standardized Approach Proposal

be focused on risk management and consistent with how the bank operates. Complexity that serves to discourage certain types of lending leads to credit allocation, which will increase the cost of credit for consumers and drive industry consolidation.

State bank regulators believe the Basel III and Standardized Approach proposals are highly reactionary to the latest crisis. We do not believe a capital regime that is reacting on a transaction-by-transaction basis to crises is good public policy or in the long-term interest of the banking system. To illustrate my point, I'll reference my counterpart from Oklahoma's comment letter on the proposals. In the letter, Oklahoma Commissioner Mick Thompson points out that the mortgage issues which underlie the financial crisis never existed in Oklahoma, but the proposed risk weights for mortgage loans in the Standardized Approach proposal will have a significant impact on banks' ability to lend. This not only affects the banks in Oklahoma, but has a direct effect on the availability and cost of credit for the citizens of Oklahoma.

Because of the remarkable diversity in the U.S. economy and in the banking industry, it is important that we focus on improving risk management and supervision, not on trying to steer individual credit decisions. This is the most logical method for addressing the types of issues that are the focus of the Basel III and Standardized Approach proposals. Simply adjusting the capital rules in response to every financial issue is not the answer. Once we head down this path, it is difficult to imagine where we will stop.

Regulation Should Address "Too Big to Fail" in a Targeted Manner

One of the primary points made by the supporters of Basel III is the need to address the weaknesses of systemic institutions. CSBS would support any rulemaking the agencies pursue to address these issues, if they are applied to the largest internationally active banks, as intended by the international accord. The Dodd-Frank Act also requires a range of measures geared toward subjecting Systemically Important Financial Institutions (SIFIs) to stricter standards, including: enhanced prudential standards; living wills; Orderly Liquidation Authority; stress testing; concentration limits; and designations. We support the efforts of the federal agencies to finalize and enforce these provisions as they are our best hope to address the problem of "too big to fail."

CSBS Positions in Brief

The federal banking agencies' rulemaking comprised three proposals to revise the U.S. regulatory capital framework. These were the Basel III, the Standardized Approach for Risk-Weighted Assets, and the Advanced Approaches proposals. I will focus my comments on the Basel III and Standardized Approach proposals, which apply to the entire commercial banking industry.

The Basel III proposal revises minimum regulatory capital levels, introduces a new common equity ratio, makes changes to the definitions of capital, re-works the Prompt Corrective Action (PCA) framework, and creates new standards in the area of Trust-Preferred Securities (TruPS). The Standardized Approach for Risk-Weighted Assets proposal outlines a radically new structure for risk-weighting assets used to calculate risk-based capital ratios. The

new risk weights will affect asset classes such as residential mortgages, certain commercial real estate loans, off-balance sheet exposures, securitizations, and equity exposures, among others.

I believe it is critical to understand the intended scope of Basel III and the actual scope of the framework the agencies have proposed. The Basel III Accord clearly states that it is intended to apply to those institutions addressed in Basel II. Basel II addresses large, internationally active banks. Basel III was never intended to apply to the entire banking industry. The framework the agencies have proposed therefore goes beyond the scope of the international agreement. It is important to further clarify that the Standardized Approach proposal is not included in the Basel III agreement. State bank regulators believe the agencies should re-evaluate the content of the proposals as a whole and re-propose Basel III to apply only to those institutions to which it was originally intended to apply. If there is a desire to raise required minimum capital for all banks, this should be pursued outside of the Basel III implementation process. The agencies have authority to establish minimum required capital. Any necessary adjustment to the minimum required capital should be proposed and justified in terms of the needs and risks of domestic institutions.

In general, the proposals are highly reactionary to the most recent crisis and attempt to remedy the various issues of the financial crisis on a transaction-by-transaction level. My fellow state bank regulators and I believe this approach is likely to yield a capital framework that is far more prone to volatility. In our estimation, regulators and policymakers do not have to address all financial vulnerabilities and risks identified during the financial crisis through capital standards. I strongly believe we should strive to address appropriate issues through risk management and the supervisory process. Additionally, state bank regulators believe the agencies have an obligation to provide empirical support for their recommended course of action, especially related to the risk-weighting figures. In many cases, there does not seem to be adequate logic to support many of the proposed risk weights. Further, as I will address in my analysis of the proposals, the agencies' proposed rules will present significant challenges for key lending markets, particularly mortgage lending.

To address the substance of the proposals more specifically, state bank regulators find the complexity of the Basel III proposal problematic and strongly oppose the proposed inclusion of gains and losses on Available for Sale (AFS) securities in capital and the proposed phase out of TruPS. Within the context of the Standardized Approach proposal, we are troubled by the proposed risk-weighting scheme for residential mortgages, High Volatility Commercial Real Estate (HVCRE), and past-due exposures. Additionally, we believe further clarity is needed surrounding the proposed treatment of securitizations and equity exposures.

The Basel III Proposal

Shifting to the specific aspects of the proposals, I reiterate that state bank regulators support efforts to improve the quantity and quality of capital in the banking system. The crisis clearly demonstrated that capital levels at many institutions, although above minimum capital ratios for regulatory purposes, were inadequate to support the risk being assumed. However, there is a balance to be struck to promote a stable banking system, which is also attractive to capital. While we do not believe the proposed minimum capital levels contained in the Basel III

proposal are unreasonable, we do believe the proposed Basel III framework is too complex. The proposal would result in too many consequential ratios and benchmarks to which institutions would have to manage. For instance, the proposed capital conservation buffer, the level of which is not necessarily problematic, becomes operationally burdensome for institutions when compared to the proposed PCA framework, which does not factor in the buffer. Situations are likely to emerge where institutions will be "well-capitalized" for PCA purposes, yet will face mandatory dividend and bonus restrictions because they are under the total capital figure that combines the minimum ratio and the conservation buffer. Such operational complexity will present tremendously awkward and confusing positions for institutions, especially those that do not have sophisticated compliance functions.

Beyond the complexity associated with the capital levels, we are very concerned about the proposed incorporation of unrealized gains and losses on AFS securities in the Common Equity ratio. This provision is not workable or meaningful for the majority of banking institutions and will skew capital ratios, generating more volatility in an institution's capital position.

We also strongly oppose the agencies' proposed treatment of TruPS in the Basel III proposal. We believe this issue was thoroughly debated in Congress. The Dodd-Frank Act established a reasonable transition period for institutions. Currently, institutions with assets below $15 billion are allowed to let TruPS roll off. The agencies have proposed a phase out schedule for these institutions beginning in 2013 and increasing 10% every year thereafter. No TruPS would qualify as capital in 2022. This provision will be detrimental for institutions that have based their long-term capital planning process on the standards established by Dodd-Frank, adding an additional layer of uncertainty for institutions' business planning.

As detailed in our Basel III comment letter,[2] CSBS encourages the agencies to revise and re-propose Basel III to focus on the institutions intended by the international agreement—large, internationally active banks. There may be reason to review and revise the general domestic capital structure but not under the Basel III umbrella, and not in the manner in which this proposal is fashioned.

The Standardized Approach Proposal

The Standardized Approach proposal is highly reactionary to the most recent crisis, does not include empirical support for the proposed risk-weightings, and, if adopted as proposed, likely will not serve our long-term economic interest. As detailed further in our comment letter,[3] the agencies have not demonstrated in the proposal an adequate understanding of the impact these adjustments would have on credit allocation and availability.

Further, when comparing the relative risk-weightings under the proposed framework across asset classes, we run into a series of internal inconsistencies. As an example, unsecured lending under the proposed rule receives a 100% risk-weighting, whereas many forms of lending backed by collateral receive well above a 100% risk-weighting. This notion defies basic banking

[2] Exhibit B: CSBS Comment Letter on Basel III NPR
[3] Exhibit C: CSBS Comment Letter on Standardized Approach for Risk-Weighted Assets

principles. Regulators and bankers generally believe that collateral is better than no collateral. The rule seems to encourage otherwise. Possibly more striking is the risk-weightings for various forms of sovereign debt compared to Acquisition, Development & Construction (ADC) loans. Sovereign debt in default receives a 150% risk-weighting under the proposed rule; the same as so-called HVCRE loans. Sovereign debt that is not in default is graded against the OECD Country Risk Classification Index. Countries like Greece, Spain, and Italy all receive excellent scores on this index, which pushes their sovereign debt risk-weighting down well below 150%. By rule, we are effectively telling our banks to invest in the struggling Eurozone long before they consider investing in the construction project down the street. In practice, I do not believe most institutions would make this choice. However, I offer this comparison as an example of the unsupported logic of some of the risk weights.

On a specific level, I am extremely concerned by the proposed treatment of residential mortgage assets in the Standardized Approach proposal. Traditionally, mortgage loans have received a 50% risk-weighting under the agencies' general risk-based capital standards. In the Standardized Approach framework, the agencies have proposed to divide an institution's mortgage loans in two categories. The criteria for achieving Category 1 status is excessively narrow, excluding traditional products that banks have originated successfully for years. Such products include standard Adjustable-Rate and balloon mortgages, Home Equity Lines of Credit (HELOCs), and second liens. The agencies have erroneously painted these products with a broad brush. These were not the products that caused the mortgage crisis and were rarely used improperly by banks. Mortgage products that do not fall in Category 1 are pushed to Category 2, where the risk-weighting is remarkably punitive, ranging from 100-200% based on origination Loan-to-Value.

This dramatic shift in treatment of mortgage assets under the risk-based capital standards would have a significantly negative effect on banks' willingness and ability to engage in mortgage lending. It is easy to assume that the mortgage securitization market encompasses the entire mortgage lending industry. But this is simply not the case. Two and a half trillion dollars in residential mortgage exposure currently resides on banks' balance sheets. Banks dedicate approximately 20% of their lending portfolios to mortgages, a figure which is consistent across the industry.[4] This is not an insignificant exposure. A reduction in mortgage lending at banking organizations will work to the detriment of mortgage credit availability, especially in rural and underserved areas. It will also take away a key source of income from banks, thereby threatening profitability and safety and soundness. It is important to note that second lien HELOCs are frequently used by homeowners to finance small businesses. The impact of the mortgage provisions therefore extend to other critical aspects of the economy.

Another concerning aspect of the Standardized Approach is the proposal's treatment of HVCRE loans. This new designation encompasses ADC loans, with some exceptions related to borrower contributions and loans financing 1-4 family residential properties. The current risk-weighting for such loans is 100%. The proposed risk-weighting is 150%. Through the risk-weighting adjustment, the agencies have essentially signaled that they do not want banks to make these types of loans. This transaction-level risk-weighting does not account for concentration risk-management and institutional expertise. ADC loans have certainly played a major role in

[4] Exhibit D: Bank balance sheet exposures to real estate related loans

many of the bank failures that have occurred over the past few years. However, the proposed treatment of HVCRE loans is a perfect example of the misuse of risk-weightings on a transactional level. Increasing risk-weightings is not the answer for every risky asset exposure. We must focus on improving risk management and supervision surrounding problematic asset concentrations. This is the most effective way to build a strong, forward-looking regulatory framework, while avoiding a "one-size-fits-all" approach.

Detailed further in our Standardized Approach comment letter are suggestions surrounding the proposed framework for off-balance sheet exposures, securitizations, and equity exposures. Generally we believe further clarity is needed in these areas for specific purposes. I will focus my remaining Standardized Approach comments on the treatment of past-due exposures in the proposal. The proposal stipulates that once a loan becomes past due, its risk weighting jumps to 150%. Here we see another provision that will introduce more volatility to the capital framework. Additionally, the proposed treatment of past-due exposures creates a "double counting" problem. Allocations for past-due loans are generally made to loan-loss reserves, thereby lowering an institution's capital level. Considering the proposed treatment of such exposures, an institution would also have to increase its risk-weighted assets in the event of a past-due loan. The effect of this, when considering regulatory capital ratios, is an increasing denominator and a decreasing numerator. The negative effect of a past-due loan is thus compounded significantly within the context of the proposal. We are also concerned that this provision of the capital rule will impact a bank's ability to prudently and effectively manage credit administration by incentivizing credit extensions. This practice can be considered unsafe and unsound.

The Standardized Approach proposal has the potential to significantly alter banks' credit decisions to the detriment of the economy. This proposal, which is not part of the Basel III Capital Accord, should be significantly revised or altogether abandoned.

A Local Perspective

It is important to remember that many institutions do not treat loans as anonymous commodities and that these proposed rules will have real consequences for institutions and communities. Here is one example. There is a small bank that is the only bank in a very rural community in Middle Tennessee. This bank has been around for almost 100 years and has a customer base that it has been serving for decades with products including mortgages that the bank holds in portfolio. The president of that bank shared with me that, based on his review of the proposed rules, when those same customers come seeking new loans, the proposed risk weights for mortgages will limit the number and volume of loans it can originate. The overwhelming community bank engagement on this topic is a testament to their passion and conviction regarding the critical role they play in our economy. We owe it to these institutions to ensure the policies we develop do not unnecessarily impede their ability to serve their communities.

There are matters within the context of the community banking business model that the industry is best equipped to address, particularly those dealing with human capital, corporate governance, succession planning, and risk management. Further, more pertinent to our world, there are adjustments we need to make to the supervisory process to facilitate progress in this

area. Specifically, we need to encourage a supervisory process that minimizes burden and disruption, provides value, and gets away from the penalty mindset and returns to a corrective, cooperative relationship. All this said, community banks will not survive if public policies irresponsibly drown them out.

Conclusion

The debate over these proposals, with meaningful and significant engagement from the industry and Congress, provides an opportunity for us to determine the appropriate approach to policy development for a diverse economy and a diverse financial system. We have an opportunity to signal to the industry and to the rest of the economy that we are committed on a going forward basis to meaningful public policy development geared toward fostering economic recovery and job growth. Further, these proposals are relevant to the debate surrounding the viability of the community banking business model. This is of deep importance to me and my colleagues from around the country. This is also important to our citizens who do not all live in large metropolitan areas or have access to the services of our largest institutions. Community banks are the lifeblood of the American economy and will be a key player in the economic recovery. Our economy is built on diversity and locality; community banking has been the backbone of this success. I strongly believe that we need to explore a regulatory framework comprising prudent and meaningful rules for community banks.

The Basel III and Standardized Approach proposals are perfect examples of policy concepts that need to be re-evaluated, better understood, and appropriately calibrated for our diverse banking system. State bank regulators have urged the agencies to significantly revise the proposed structure, so we have a regulatory capital framework that is meaningful for community banks and consistent with the practices of the business model.

CSBS stands ready to work with Members of Congress and our federal counterparts in seeking the appropriate regulatory balance and pursuing our collective goal of restoring stability to the American economy.

Thank you for the opportunity to testify today, and I look forward to answering any questions you have.

Exhibits

Exhibit A: CSBS Comment Letter on FDIC Initial Regulatory Flexibility Act Analysis

Exhibit B: CSBS Comment Letter on Basel III Proposal

Exhibit C: CSBS Comment Letter on Standardized Approach Proposal

Exhibit D: Data on Bank Real Estate Exposures

CONFERENCE OF STATE BANK SUPERVISORS

November 14, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AD96

Dear Mr. Feldman,

The Conference of State Bank Supervisors (CSBS) is pleased to comment on the Federal Deposit Insurance Corporation's (FDIC's) Initial Regulatory Flexibility Analysis (IRFA) for its Notice of Proposed Rulemaking (NPR) entitled *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements* (Standardized Approach proposal).

Section 3(a) of the Regulatory Flexibility Act (RFA) requires an agency to publish in the Federal Register an IRFA or a summary of its IRFA, or to certify that the proposed rule will not have a significant economic impact on a substantial number of small entities. For purposes of the IRFA, a small entity includes a banking organization with total assets of $175 million or less.

The FDIC published this IRFA addressing the Standardized Approach Proposal on October 17, 2012 separately from the Federal Reserve Board (FRB) and the Office of the Comptroller of the Currency (OCC), the two agencies with which the FDIC published the proposed rule.

FDIC CONCLUSIONS

As detailed in the IRFA, to determine if the Standardized Approach proposal would have a significant economic impact on small banks and savings associations, the FDIC compared the estimated annual cost with annual noninterest expense and annual salaries and employee benefits for each institution. If the estimated annual cost was greater than or equal to 2.5 percent of total noninterest expense or 5 percent of annual salaries and employee benefits, the FDIC classified the impact as significant. The FDIC has concluded that the proposals included in the NPR would exceed this threshold for 2,413 small state nonmember banks, 114 small savings banks, and 45 small state savings institutions. Accordingly, for the purposes of this IRFA, the FDIC has concluded that the changes proposed in the Standardized Approach NPR, when considered without regard to other changes to the capital requirements that the agencies simultaneously are proposing, would have a significant economic impact on a substantial number of small banks and savings associations. Further, if both the Standardized Approach NPR and the Basel III NPR were adopted together, the impact on small institutions would increase.

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Economic Impact

In our comments to the agencies on the Basel III and Standardized Approach proposed rules, we highlighted the potentially negative impact the proposals could have on the economy and on job growth. It seems the analysis conducted in the FDIC's IRFA supports our projections. The FDIC has estimated that the Standardized Approach proposal will have a significant impact on 2,413 institutions with assets below $175 million that are under the agency's regulatory purview. This is clearly a significant number of institutions. It is important to note that this analysis was only performed for those institutions below $175 million in assets. The same type of analysis, if applied to the rest of the industry, may yield more striking results.

As detailed in our comment letters, we support the effort to quantify the impact these proposals could have on the industry. We therefore endorse the FDIC's work in this area, and we believe the FDIC employed a thoughtful and sound methodology to evaluate the potential impact on small institutions. Given the fact that this analysis has yielded a positive affirmation that the proposals would have a significant economic impact on at least those institutions below the RFA threshold, we strongly urge the FDIC and the other agencies to consider measures that may be taken to lessen the potentially negative impact their proposals may have on the general economy and on job growth.

Inconsistency in Evaluation

CSBS would like to note the inconsistent fashion in which the agencies have performed their required IRFAs on the Basel III and Standardized Approach proposals. We understand the agencies' obligation is to focus on the institutions they individually regulate. However, we find it troubling that the agencies seem not to have worked closely on these analyses and did not develop a common understanding of the proposals' potential impact. All the agencies performed an IRFA on the Basel III proposal and published some preliminary economic impact dialogue in the Standardized Approach proposal. The methodologies the agencies have used to evaluate the proposals' impact are different, and the conclusions are not consistent.

We believe it is important for the agencies to establish a unified understanding of the potential economic impact the Basel III and Standardized Approach proposals would have on the industry before releasing proposals of this magnitude. We note that the FDIC's supplemental analysis was released only four business days before the end of the comment period for the proposal in question. The FRB and OCC still have not released their own supplemental analyses referenced in the FDIC's notice. The FDIC maintains that any comments on this notice will be considered in the development of a final rule. However, we believe the utility of the IRFA is significantly minimized since the public was not able to supplement its analysis of the proposals themselves with the agencies' projections.

Overall, we are concerned that the inconsistent approach employed by the agencies to evaluate the impact of the proposals, combined with the actual conclusion of the analysis, which is not encouraging, contribute to the uncertainty surrounding the proposals and the need to re-evaluate their structure.

Sincerely,

John W. Ryan
President and CEO

Exhibit B

CONFERENCE OF STATE BANK SUPERVISORS

October 17, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AD95

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington DC, 20219
Docket ID OCC-2012-0008

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1430;
RIN No. 7100-AD87

Dear Sir or Madam,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC's), the Board of Governors of the Federal Reserve System's (FRB's), and the Office of the Comptroller of the Currency's (OCC's) (collectively, "the Agencies") joint Notice of Proposed Rulemaking (NPR, proposal, or proposed rule) to implement the Basel III capital accords, entitled *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action.*

In our view, the proposed rule is one of the most significant public policy matters facing the financial sector. The appropriate level of capital should enhance the resiliency of the banking sector, allowing institutions to remain solvent through the economic cycle. However, too much capital can have undesirable effects on the industry. Too much capital can have the effect of increasing management's tolerance for risk as they strive to provide a return for stockholders. An overly restrictive capital requirement also serves as a barrier to entry, discouraging capital from entering the banking system and further driving industry consolidation. It is critical to strike the appropriate balance to achieve a stable banking system, which is attractive to capital, and can serve as the backbone to a vibrant and diverse economy. This comment period provides a critical opportunity for the public to express its views on the proposed rules and the potential impact they will have on banks, credit availability, and economic growth. We encourage the Agencies to consider not only the calibration of capital requirements to ensure a resilient banking system, but also what is in the best interest of both the national and local

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economies. Capital requirements must factor in the existence of an active supervisory function and a resolution regime, which works as designed for the vast majority of banks.

We have provided feedback on the Agencies' Standardized Approach proposed rule in a separate comment letter. Our comments on the Basel III proposed rule are organized in the sections below.

Introduction

We support the Agencies' efforts to increase the minimum required capital. However, we are concerned with the ability to achieve this under the Basel III umbrella. The international agreement clearly states it is intended to cover the same institutions covered under Basel II,[1] which targets only large, internationally active banks. The agreement was never intended to apply to all U.S. banks. We recommend the Agencies scale back this rulemaking to apply only to the intended institutions. We would support a separate rulemaking to address the minimum capital requirements for banks not covered by Basel II and Basel III. The proposed rule should be appropriately calibrated to enhance stability while serving to attract capital to the system. The proposed rule must be easy to understand and simple to manage. We believe the public comments to this rulemaking will provide the Agencies sufficient feedback to effectively structure a new proposal.

Minimum Capital Ratios

CSBS generally supports a higher level of high quality capital at banking organizations. The financial crisis clearly demonstrated that capital levels meeting minimum capital requirements for regulatory purposes are not adequate for practical purposes during stressful conditions. Considering the experience of the US financial crisis, the Agencies have proposed to introduce higher minimum capital requirements for banking organizations.

Specifically, the Agencies have proposed to eliminate the exception for CAMELS 1 rated institutions to maintain a Tier 1 Leverage Ratio of 3%. All institutions will now have to adhere to a Tier 1 Leverage Ratio of 4%. CSBS supports a higher minimum Tier 1 Leverage Ratio. Practically, 4% is not an adequate level of operating capital for all institutions. We support the Agencies' comments regarding the need for institutions to hold capital commensurate with the risks and complexity of their business activity, regardless of the regulatory capital ratios.

Additionally, the Agencies have proposed a new Tier 1 Common Equity Capital ratio. Institutions would have to maintain a minimum Tier 1 Common Equity ratio of 4.5% to meet minimum capital requirements. CSBS supports a renewed focus on common equity, as this is the strongest form of capital. Community banks typically hold a higher percentage of common equity than larger institutions. A new common equity ratio should contribute to a more level playing field between community banks and large banks. As discussed further below, we do not support the proposal to include unrealized gains and losses on available for sale securities

[1] Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010, page 11.

in the definition of Tier 1 Common Equity. Nevertheless, we generally support the common equity ratio and believe it will enhance the quality of capital positions across the industry.

For Tier 1 Risk-Based Capital, the Agencies have proposed to increase the minimum ratio from 4% to 6%. We support the increase in Tier 1 Risk-Based Capital. The Agencies have not proposed to adjust the current Total Risk-Based Capital Ratio of 8%.

CAPITAL CONSERVATION BUFFER

The Agencies have proposed that institutions hold a capital conservation buffer comprising common equity tier 1 capital. The buffer represents an additional 2.5% of total risk-weighted assets. The buffer must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments. This has the effect of increasing the minimum risk based capital ratios by 250 basis points.

While we support requiring greater amounts of high quality capital, to the extent the capital conservation buffer introduces undue operational complexity for institutions, we believe regulators should work to clarify expectations. As discussed further in the Prompt Corrective Action (PCA) section of this letter, the number of consequential capital ratios detailed in the proposal to which institutions would have to adhere would introduce undue complexity to the capital planning process for banking organizations.

COUNTERCYCLICAL CAPITAL BUFFER AND SUPPLEMENTAL RATIO

The Agencies have proposed to implement the Basel III countercyclical capital buffer for advanced approaches institutions, which generally includes institutions with assets above $250 billion. The countercyclical capital buffer would be based on detailed market indicators and would require larger institutions to hold up to 2.5% of additional risk-based capital. CSBS supports the Agencies' proposal to apply the countercyclical capital buffer only to institutions with assets above $250 billion. Larger institutions have greater access to capital markets, which will allow them to more reasonably meet the requirements of the countercyclical buffer. We also support the theoretical structure of the countercyclical capital buffer as it applies to advanced approaches institutions.

Additionally, advanced approaches institutions would be required to maintain a supplementary leverage ratio of tier 1 capital to total leverage exposure of 3%. We support the supplementary leverage provision. However, the off-balance sheet exposures and repo style transactions the Agencies site in support of this requirement occur frequently at large institutions that do not meet the advanced approaches criteria. The Agencies may consider application of the supplementary leverage ratio to classes of institutions with assets below $250 billion but not less than $50 billion on a case by case basis.

PROMPT CORRECTIVE ACTION

The Agencies have proposed a method for incorporating changes to minimum capital ratios in the Prompt Corrective Action (PCA) framework. The proposed PCA framework includes new

ratios corresponding to the various capitalization designations contained in PCA. Notably, the proposal does not factor the capital conservation buffer in the PCA ratios.

In our view, under the current proposal, institutions will have to manage their capital levels with too many consequential measures in mind. The proposals include new minimum capital requirements, new additional capital requirements for capital conservation buffer purposes, and new PCA requirements. The Agencies should work to streamline the PCA requirements to acknowledge the presence of the capital conservation buffer and clarify the implications associated with the various thresholds. We should work to minimize the operational complexity at institutions that can arise from numerous regulatory capital measures.

The currently proposed framework presents an awkward situation for institutions. For instance, the proposed measure of total risk-based capital to be considered "well-capitalized" for PCA purposes is 10%, yet the minimum total risk-based capital ratio including the 2.5% capital conservation buffer is 10.5%. Therefore, institutions may be "well-capitalized" but still have mandatory restrictions on dividend and bonus payouts. We encourage the Agencies to acknowledge and resolve such discrepancies that may result in confusion for bank management.

UNREALIZED GAINS AND LOSSES ON SECURITIES IN COMMON EQUITY TIER 1 CAPITAL

Under the Agencies' current general risk-based capital rules, unrealized gains and losses on Available For Sale (AFS) debt securities are not included in regulatory capital, unrealized losses on AFS equity securities are include in tier 1 capital, and unrealized gains on AFS equity securities are partially included in tier 2 capital. Under the proposal, unrealized gains and losses on all AFS securities would flow through to common equity tier 1 capital.

CSBS does not believe this provision is workable or meaningful for banking organizations. Including gains and losses on AFS securities in the common equity ratio would introduce significant volatility in capital ratios and potentially skew institutions' capital positions both in times of crisis and in periods of stability. The frequency and extent to which the proposed provision would adjust capital positions would be substantial. We believe capital measurements that are built on potentially significant volatility are not meaningful and may have detrimental consequences for the safety and soundness of our banking industry. We are concerned that this provision may cause banks to engage in transactions that they otherwise would not out of fear of the impact of potential future losses from changing market conditions. Incorporating this element of volatility into the capital framework is not in the long-term best interest of individual banks or the banking system.

The proposal offers possible alternatives, including excluding the impact solely from changes in interest rates and excluding U.S. government and agency securities. Firms that provide investment advisory services to the industry believe this will be nearly impossible to accurately quantify on a consistent basis. The Agencies should adequately research this perspective before finalizing any rule to ensure the option is workable and meaningful. To be clear, we believe the existing framework is more applicable to a traditional bank and provides for less complexity and greater stability.

<u>TRUST PREFERRED SECURITIES</u>

Basel III eliminates Trust Preferred Securities (TPS) as qualifying capital for all banks and bank holding companies above $500 million in assets. For bank holding companies with assets above $15 billion, the Basel III proposal maintains consistency with Dodd-Frank, retaining a phase-out period ending in 2016. For bank holding companies with assets between $500 million and $15 billion, the Agencies have proposed a phase-out schedule beginning at 10% in 2013 and increasing 10% a year for 10 years. No TPS would count beginning in 2022. The proposed treatment of TPS deviates from Dodd-Frank, which allows bank holding companies between $500 million and $15 billion to let the TPS roll-off.

CSBS strongly opposes the Agencies' proposed treatment of TPS for institutions between $500 million and $15 billion. The proposed rule represents a new and unnecessary extreme in the area of TPS. We are troubled by the Agencies' inclination to deviate from the Dodd-Frank standard. Implementing a sudden shift in policy related to TPS may have significantly negative consequences for institutions' capital planning strategies. Further, CSBS believes this matter was thoroughly reviewed in Congress during Dodd-Frank deliberations, and Congress elected to establish the framework detailed above for good reason. We therefore urge the Agencies to withdraw their proposed phase-out of TPS for institutions between $500 million and $15 billion and maintain the framework established by Congress.

<u>CAPITAL TRANSITION PROVISIONS AND INFORMATION GAPS</u>

CSBS generally believes the Agencies have proposed reasonable transition provisions for institutional compliance with the proposed capital requirements if the requirements are imposed.

We would also like to note that a number of information gaps exist in current financial reporting requirements that will make it difficult to assess the potential impact of various provisions of the proposal. Specifically, financial positions such as Deferred Tax Assets (DTAs) are not reflected in current regulatory reports in adequate detail, yet there are a number of proposed provisions affecting these assets. In order to adequately measure the impact of such requirements, we need to address reporting gaps in these areas.

<u>CONCLUSION</u>
We are supportive of the Agencies' efforts to improve the level and quality of minimum required capital. We strongly recommend the Agencies pursue a more simplistic and effective proposal appropriate for a diverse banking system which is largely dominated by less complex, community based institutions.

As the Agencies consider a revised and narrower proposal, it is important to be able to quantify the impact on the industry. We appreciate the Agencies' efforts to develop the capital estimation tool for banks to analyze the potential impact of this rule and the proposed rule for the Standardized Approach. We believe it is imperative for the Agencies to understand the impact on an aggregate basis and, more importantly, have a better sense of how changes in the capital rules will impact the bank's origination of credit.

Best regards,

John W. Ryan
President & CEO

Exhibit C

CONFERENCE OF STATE BANK SUPERVISORS

October 17, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064-AD96

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington DC, 20219
Docket ID OCC-2012-0009

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1442;
RIN No. 7100-AD87

Dear Sir or Madam,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC's), the Board of Governors of the Federal Reserve System's (FRB's), and the Office of the Comptroller of the Currency's (OCC's) (collectively, "the Agencies") joint Notice of Proposed Rulemaking (NPR, proposal, or proposed rule) to adjust the Agencies' general risk-based capital requirements for determining risk-weighted assets, entitled *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements.*

CSBS supports the Agencies' efforts to improve capital standards for the US banking system. We hope the Agencies will work to establish standards that are in the best interest of all financial institutions and the larger US economy. We have provided feedback on the Agencies' Basel III proposed rule in a separate comment letter. Our comments on the Standardized Approach proposed rule are organized in the sections below.

SUMMARY OF CSBS POSITION

CSBS is opposed to the proposed rule to revise the risk weights for risk-based capital. We come to this very clear position after extensive study of the proposal and dialogue with state supervisors. This position is based on the following concerns and beliefs:

1. The proposed rule is reactionary to the most recent crisis with a focus on housing and commercial real estate.

1129 20TH STREET, N.W. • NINTH FLOOR • WASHINGTON, DC • 20036
WWW.CSBS.ORG • 202-296-2840 • FAX 202-296-1928

2. The approach proposed by the Agencies will curtail bank lending in traditional mortgage products that they have generally managed well.
3. There is no empirical support for the proposed risk weights.
4. As we seek to address concerns that emerged from the financial crisis, greater appreciation must be paid to risk management and the supervisory process to address evolving risk concentrations rather than capital weightings of broad asset types based solely on imperfect correlations perceived from the last crisis.
5. The proposed framework is overly complex.
6. There is not sufficient understanding of the impact of the proposed rule on the industry, the potential change in business practices, and the impact on credit availability.

The approach taken by the Agencies is targeted at the major risk drivers for problem banks during this crisis. However, while over 450 institutions failed from 2008 through the present, we must remember that the majority of institutions did not fail. In fact, out of the nearly 2,300 banks with concentrations in commercial real estate loans in 2007, over 1,200 maintained a low level of problem assets and are profitable today.

As we seek to improve the quality and quantity of capital, we believe it is important to resist the temptation to address every financial weakness through capital. We must seek to apply lessons learned to improving risk management and the supervision process. If not, we will continuously seek to make the industry more risk averse, which will curtail access to credit and harm economic growth.

CSBS has supported prior agency efforts to enhance the risk sensitivity of the capital rules. We commented in January 2006:

> "a successful domestic capital framework will not only benefit individual financial institutions which effectively utilize risk management tools, but will also benefit the banking system as a whole by providing greater ability to effectively and efficiently manage capital."

The challenge before the Agencies is to do this while not adding complexity. We do not believe the rule as proposed meets these objectives. The proposed rule is not balanced in its treatment of exposures and will present undue complexity for the industry. Unfortunately, we must recognize that risk-based capital has limited utility for bank management. Bankers have clearly communicated to state commissioners that they view this as a regulatory exercise, not a tool for risk management. We must question the value of a proposed regulation which provides little or no value to the industry. As state and federal supervisors find value in the framework, we believe it would be worthwhile to enhance our collective understanding on a framework which would prove valuable for the industry and the regulators.

In order to truly improve the risk sensitivity of the capital rules, the categorization of exposures and risk weights need to be supported. The categorization of assets should be aligned with the variety of practices of banks for the origination of credit, while accepting that banks have

different levels and areas of expertise and appetite for risk. The assigned risk weights must have a reasonable correlation with the risk and not be used as a tool for the allocation of credit and the creation of an overall more conservative industry.

In the implementation of Basel II, the Agencies went through a series of "Quantitative Impact Studies." This was important to understand the impact on banks and the ability to conform to the framework. From this, public policy makers and observers were able to judge and opine on the readiness of institutions, the impact on the banks, and the potential changes to the credit markets and availability. While a comprehensive impact study would create its own burdens, the system and the economy are ill-served by not having a better understanding of the desirable and undesirable ramifications of changing the risk weights in the manner proposed. Based on industry reactions, the proposal will clearly have a negative impact on credit allocation. Policy makers have a responsibility to understand these changes and evaluate the potential impact on the banking system and economy.

RESIDENTIAL MORTGAGE EXPOSURES

Current risk-based capital requirements generally prescribe a 50% risk-weighting for residential mortgage exposures. The proposed rule introduces a complex scheme for risk-weighting residential mortgage exposures. This process divides residential mortgage exposures into two categories: Category 1 and Category 2. The Agencies have proposed a detailed set of standards that mortgages must meet in order to achieve Category 1 status. Among other criteria, Category 1 mortgages must be fully amortizing, without a balloon payment, and meet strict underwriting criteria. Any mortgage that does not meet the Category 1 criteria would be deemed a Category 2 mortgage.

Once a mortgage is categorized, its risk-weighting would be assigned based on the Loan-to-Value (LTV) ratio of the loan within the eligible risk-weighting range of the category. Category 1 mortgages would be assigned a risk-weighting between 35% and 100% based on LTV. Category 2 mortgages would be assigned a risk-weighting between 100% and 200% based on LTV.

CSBS believes the proposed treatment of residential mortgage exposures will have a detrimental effect on access to mortgage credit. We strongly oppose the proposed scheme for risk-weighting residential mortgage exposures, and we urge the Agencies to re-work or abandon the proposed approach. Chief among our concerns is the excessively narrow criteria for Category 1 mortgages. In our estimation, traditional products such as adjustable-rate mortgages (ARMs) and other products with balloon features would not qualify as Category 1, subjecting them to the Category 2 risk weights. Many banks also offer second lien and Home Equity Lines of Credit (HELOCs). This is an important source of credit for consumers and small businesses. These loans would also be designated as Category 2. The highly punitive risk-weightings for all mortgages in Category 2 would effectively discourage institutions from engaging in such transactions. Thus, designation of these transactions as Category 2 loans will largely eliminate an important source of credit for consumers and small businesses and a reliable business line for the institutions, thereby restricting access to credit and negatively impacting the safety and soundness of banking institutions, and the overall economy.

We are concerned that the rule unnecessarily paints these products with a very broad brush. This could have an impact on the availability of certain loan products. There were certainly problems with some adjustable rate and balloon products in the financial crisis. However, these problems should be addressed in a manner that does not inhibit traditional products that banks have managed successfully and that have benefited consumers. The legitimate concerns generated from the poor underwriting and risk management practices of a few institutions should not be addressed through a capital rule applicable to the entire industry. If the proposal is adopted in its current form, the banking industry will enter a counterintuitive phase whereby unsecured loans, which receive a 100% risk-weighting under the proposal, will effectively be deemed safer than many loans secured by collateral, a concept that contradicts the basic principles of banking. Furthermore, the proposed risk-weighting framework will push more residential mortgage business into lines that receive government support, as most government sponsored mortgage programs receive a low risk-weighting under the proposal.

It is critical to acknowledge that while the residential mortgage industry is vast, and a large portion of mortgage activity takes place off banks' books, the volume of residential mortgage exposure held in portfolio at banking organizations is not at all insignificant. Indeed, the commercial banking industry holds over $2 trillion in residential mortgage exposure in portfolio. Notably, residential mortgage exposures comprise an average of 17% of a bank's assets. While the securitization market has become the dominant source of mortgage funding, the assumption that this is not an important exposure for banks is incorrect. A bank's ability to originate and hold residential mortgage product is an important part of its asset mix and allows for a customization of credit beneficial for the consumer. Public policy should not inhibit this activity.

In a period where a coherent plan for addressing broader housing finance reform has not emerged, we believe this proposal, which would limit residential mortgage activity at institutions that are willing to take on the risk associated with this important class of credit, is ill-advised.

High Volatility Commercial Real Estate (HVCRE)

Current risk-based capital requirements prescribe a 100% risk-weighting for acquisition, development, and construction (ADC) loans. The Agencies have proposed a new risk-weighting for High Volatility Commercial Real Estate (HVCRE) loans. An HVCRE loan would be defined as a credit facility that finances or has financed the acquisition, development, or construction of real property, unless the facility finances one-to four-family residential properties or commercial real estate projects that demonstrate certain LTV or borrower contribution standards. HVCRE loans would receive a 150% risk weighting under the proposal.

The impact of the proposed treatment of HVCRE loans could have negative unintended consequences for banks and the broader economy. The proposed approach, with a highly punitive risk weight, fails to adequately account for an institution's experience and expertise in this type of lending, the adequacy of its policies and procedures, and the level of concentration. Issues with development and construction lending should be addressed at the risk management

level and through the supervisory process. The proposed 150% risk weighting is effectively telling institutions not to engage in this type of lending.

Strikingly, under the proposed rule, sovereign debt that is in default receives the same risk-weighting treatment as the construction and development loans detailed above. Other sovereign debt in substantially struggling countries that are not in default receives a potentially more attractive risk-weighting than HVCRE loans. Considering these relative risk-weightings, the Agencies are effectively signaling to banking organizations that investing in struggling countries such as Greece is as sound as investing in real estate projects in their local communities. This implied direction will cause many banking institutions, particularly community banks, to re-evaluate their asset mix to the detriment of community focused business lending.

We recognize construction and development lending has posed significant risks for many community banks over the past few years. However, as discussed above, to the extent a construction and development loan poses safety and soundness issues for an institution, those issues should be addressed through the supervisory process. The Agencies should not feel compelled to penalize broad types of transactions through capital rules rather than addressing the concentrations that were problematic during the last crisis. Further, it is important to note that while many community banks struggled in their risk assessment of construction and development loans, many more were successful and prudent in construction and development lending. The successful banks frequently established loan concentration limits that forced them to engage in prudent risk selection which recognized the distinct differences within broad loan types. CSBS therefore urges the Agencies to re-contemplate the proposed framework for HVCRE loans.

PAST DUE EXPOSURES

Under current general risk-based capital rules, the risk weighting of an exposure does not change if it becomes past due, with the exception of residential mortgage loans. In the NPR, the Agencies have proposed to require banking organizations to assign a risk-weight of 150% to an exposure that is not guaranteed or not secured if it is 90 days or more past due or on nonaccrual.

This provision will introduce more volatility and potentially sudden shocks into the capital planning process. Additionally, we note that levels of past due exposures may change frequently from quarter to quarter. We should strive to establish provisions that will not cause frequent fluctuations in risk-weighted assets on a quarterly basis.

CSBS would also like to point out that increasing the risk-weighting for past due loans involves some measure of “double-counting.” When an exposure becomes past due, there are generally allowance provisions that require institutions to reserve capital for those exposures in case they default, effectively lowering institutions’ capital levels. Therefore, increasing the risk-weighting for past due loans will effectively adjust both the numerator and denominator in risk-based capital ratios, compounding the negative effect on the ratio.

Finally, it is important to note that there exist classes of past due loans that are designated as such for administrative reasons. For example, exposures may be past due while institutions are waiting on financial statements, appraisals, or other pertinent financial information. In these cases, institutions will refrain from renewing the loan until the technical issues are resolved. We do not believe institutions should have to hold additional capital against these types of past due exposures.

Off-Balance Sheet Exposures

Within the context of off-balance sheet exposures, the NPR states that if a banking organization 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% credit conversion factor to the exposure amount. While it appears that standard representations and warranties for fraud, misrepresentation, & documentation deficiencies that have traditionally accompanied secondary market sales of mortgages to investors would be exempted from the risk-based capital requirements, we request the Agencies explicitly clarify whether these traditional representations and warranties are indeed exempt. We believe that requiring institutions to hold capital against these representations and warranties will have detrimental consequences for mortgage banking.

Securitizations

Dodd-Frank requires financial regulators to strip references to credit ratings from their regulations. This clearly has an implication for securitizations, as the risk-weighting framework in this area has traditionally referenced credit ratings. Under the proposal, a banking organization would generally calculate a risk-weighted asset amount for a securitization exposure by applying either: (1) the simplified supervisory formula approach (SSFA), or (2) for banking organizations not subject to the market risk rule, a gross-up approach similar to an approach provided under the general risk-based capital rules. Alternatively, a banking organization may choose to apply a 1,250% risk weight to any of its securitization exposures.

We acknowledge that the Agencies are required to adjust their regulations in this area to account for the Dodd-Frank mandate. We would like to note that the proposed approaches for measurement and due diligence requirements, which generally require complex methods of evaluating the underlying collateral in securitizations, may be difficult for community banks to administer, and the alternative proposed risk-weighting is punitive. CSBS encourages the Agencies to explore a simpler method for applying these standards to community banks. We are concerned the proposed approach will significantly impair an institution's ability to manage its balance sheet through the economic cycle. We believe that in order to have a vibrant and diverse banking system, banks of all sizes need the ability to manage the balance sheet with a variety of exposures.

Equity Exposures

Under the proposal, a banking organization would determine the risk-weighted asset amount for each equity exposure by multiplying the adjusted carrying value of the equity exposure by

the applicable risk weight set out in the Agencies' proposed Simple Risk-weight Approach Table for equity exposures. The proposal also permits banking organizations to apply a 100% risk weighting to certain equity exposures deemed non-significant.

The Simple Risk-weight Approach Table is straightforward. However, we believe the scope of the 400% equity exposure category applied to non-publicly traded entities should be clarified. We would be particularly concerned if this risk-weighting is assigned to equity exposures such as stock ownership in bankers' banks. It seems that stock ownership in bankers' banks might qualify as a non-significant equity exposure if the ownership meets certain characteristics, thereby achieving a lower risk-weighting. Nevertheless, the industry would benefit from clarity in this area. The Agencies also inquire as to whether they should explore an alternative proposal to simplify the risk-based capital treatment of banking organizations' non-significant equity exposures. We support such an effort.

OTC Derivatives

CSBS requests clarity on what is meant by "netting" within the context of OTC Derivatives in the proposed rule. Netting occurs in many forms. If the proposed rule is simply referring to netting within the context of various master netting agreements, we would like to note that the definition of netting within those agreements can vary widely. To the extent institutions comply with this provision, the Agencies should be aware of the variety of netting arrangements that exist under the master agreements.

Market Discipline and Disclosure Requirements

The Basel Committee on Banking Supervision (BCBS) introduced additional capital disclosure requirements in its 2011 paper entitled, "Definition of Capital Disclosure Requirements." The Agencies are proposing to apply these disclosure requirements to banking organizations with assets greater than $50 billion. CSBS endorses the Agencies' proposed disclosure requirements for large institutions. However, it is important to ensure that these requirements will not flow down to community banks in the future. We generally do not believe that the specific disclosure requirements would be necessary for smaller banks or beneficial to community bank stakeholders.

Regulatory Flexibility Act Analysis

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 requires an agency to provide an initial regulatory flexibility analysis with a proposed rule or to certify that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banking entities with assets less than or equal to $175 million).

We are troubled by the inconsistent and, in our view, inadequate approach the Agencies took in addressing this requirement. The FDIC and the OCC certify in their analyses that the Basel III and Standardized Approach NPRs, taken together, "appear to have a significant economic impact on a substantial number of small entities." The Federal Reserve's analysis is less conclusive.

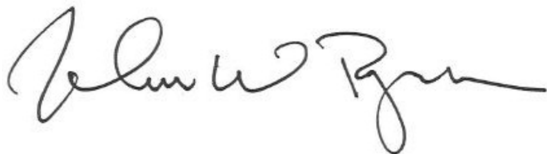
CONCLUSION

The proposed rule provides an important opportunity for the industry and policy makers to debate how various rules should apply to a variety of institutions. The Agencies deserve credit for the extensive outreach they have conducted to ensure the industry understands the proposal. This process should yield the Agencies valuable information on the potential impact that this proposed rule will have on banking operations, access to credit and the broader economy. We believe this is an important opportunity for the Agencies to consider what is realistic and practical for a variety of institutions, appreciating the diversity of the system.

We believe it is important for the capital rules to take a long-term view of the industry and exposures. In this regard, broad risk weights have served regulators reasonably well, with specific information about risk exposures supplemented by supervision. While it can be tempting to attempt to fine tune the risk identification, there is a fine line between enhanced risk sensitivity and credit allocation.

Most importantly, we believe it is imperative to understand the potential impact not only on capital in the banks but also on their behavior in originating credit. An overly conservative industry will not be in the position to serve consumers or local economies. We appreciate that the Agencies must do certain things to comply with the Basel III international accord and the Dodd-Frank Act. The Agencies should pursue a rulemaking with the absolute minimum changes required to comply with the law. We strongly encourage the Agencies to undertake a larger study to evaluate long-term capital standards under a framework which meets the needs of regulators and is consistent with the variety of business models of our banking industry.

Best regards,



John W. Ryan
President & CEO

Exhibit D

Banks and Real Estate Exposures

Banks by Asset Size	# Banks	%	Proportion of RE Exposures	Allocation of RE Exposures 1-4 Family	C&D	CRE	Ag
Less than 100MM	2,375	33%	1%	1%	1%	1%	11%
100MM to 500MM	3,533	49%	6%	6%	14%	14%	38%
500MM to 1 Billion	691	10%	3%	4%	10%	9%	13%
1B to 10 Billion	552	8%	10%	11%	24%	25%	19%
10B to 50 Billion	72	1%	10%	14%	10%	13%	7%
50 Billion +	36	0%	70%	64%	40%	38%	12%
Totals	7,259	100%	100%	100%	100%	100%	100%

Banks by Asset Size	# Banks	Assets (000)	1-4 Family Related Loans $ (000)	% of Assets
Less than 100MM	2,375	135,185,376	25,048,899	19%
100MM to 500MM	3,533	795,179,339	157,219,937	20%
500MM to 1 Billion	691	475,620,093	94,340,971	20%
1B to 10 Billion	552	1,422,243,720	264,904,005	19%
10B to 50 Billion	72	1,414,753,694	339,362,507	24%
50 Billion +	36	9,795,843,302	1,571,946,188	16%
Totals	7,259	14,038,825,524	2,452,822,507	17%

Source: SNL Financial