Frequently Asked Questions about FDIC Vice Chairman Hoenig's Recommendations for Regulatory Relief for Traditional Banks

1. What criteria do you recommend for banks to be eligible for regulatory relief?

Banks that emphasize the core commercial banking model and have strong equity capital, defined specifically as banks that:

- hold no trading assets or liabilities;
- hold no derivative positions other than interest rate and foreign exchange derivatives;
- have a total notional value of all their derivatives exposures - including cleared and non-cleared derivatives – that is less than $8 billion; and
- maintain a ratio of Generally Accepted Accounting Principles equity-to-assets of at least 10%

2. What is the size threshold for banks to be eligible for regulatory relief under Hoenig's plan?

Size does not limit eligibility for regulatory relief using the metric outlined above because it is defined based on activity rather than asset size. A bank of any size that meets the criteria would be eligible for regulatory relief.

3. What banks currently are eligible?

More than 90 percent of the approximately 6,400 commercial banks in the US meet the first three criteria, and two-thirds of them meet the fourth criterion regarding capital. The remaining one-third of these banks are within two percentage points of the capital requirement and could be afforded relief as they achieve this objective over a 24-month phase-in period. Among banks that would qualify are 18 regional banks - one with assets exceeding $104 billion. Given meaningful regulatory relief, many other regional banks, which are already close to meeting these thresholds, could choose to follow suit.

4. What specific relief do you recommend for eligible banks?

- Exempting these more traditional banks from all Basel capital standards and associated risk-weighted asset calculations.
- Exempting these banks from several entire schedules on the call report.

- Allowing for greater examiner discretion and eliminating requirements to refer "all possible or apparent fair lending violations to Justice" if judged to be minimal or inadvertent.
- Establishing further criteria that would exempt eligible banks from appraisal requirements
- Exempting banks, if applicable, from stress testing requirements.
- Where judged appropriate, allowing for an 18-month examination cycle as opposed to the current required 12-month cycle for traditional banks.
- Mortgages made by these traditional banks that remain in the banks' portfolio would be a qualified mortgage loan for purposes of Dodd-Frank Act.

5. Why don't you include the Volcker Rule on the list of regulations you recommend easing for traditional banks?

The vast majority of community banks have virtually no compliance burden associated with implementing the Volcker Rule. Not only do these banks not have proprietary trading operations, but they generally have no trading positions of any kind. In addition, community banks generally do not invest in any private-label securitizations, let alone more complicated hedge funds or private equity funds.

As existing guidance[1] already details, community banks with less than $10 billion in total assets are already exempt from all of the Volcker Rule compliance requirements if they do not engage in any of the covered activities other than trading in certain government, agency, state, and municipal obligations. This is the case for the vast majority of community banks. For community banks which are receiving conflicting information from consultants, regulators should clarify or expand the current guidance to eliminate the confusion.

For the banks under $10 billion that do engage in traditional hedging activities, existing guidance should be updated to clarify that Volcker Rule compliance requirements can be met by simply having clear policies and procedures that place appropriate controls on the activities -- and which are required regardless of the Volcker Rule. The existence and appropriateness of such policies and procedures can be verified by examiners as part of the regular exam process, and would not require extra compliance assistance from consultants.

Finally, some banks under $10 billion do engage in less-traditional activities that may be restricted by the Volcker Rule. For these banks, there would be some initial compliance requirements to determine their status. These banks represent less than 400 of a total of approximately 6,400 smaller banks in the US. And of these 400, most will find that their trading-like activities are already exempt from the Volcker Rule. However, some smaller banks do engage in riskier activities that should not be backstopped by the taxpayer, for example, investments in collateralized debt obligations, trading of equity options, investments in collateralized loan obligations, and investments in auction rate securities. If these few banks have

[1] https://fdic.gov/regulations/reform/volcker/summary.html

the expertise to engage in these risky activities, they should also have the expertise to comply with Volcker Rule.

On balance, therefore, a blanket exemption for smaller institutions to engage in proprietary trading and yet be exempt from the Volcker Rule is unwise. A blanket exemption would provide no meaningful regulatory burden relief for the vast majority of community banks that do not engage at all in the activities that the Volcker Rule restricts. However, a blanket exemption for this subset of banks would invite the group to use taxpayer subsidized funds to engage in proprietary trading and investment activities that should be conducted in the marketplace, outside of the safety net.

6. Why do you recommend legislation to ease these requirements, instead of doing it through the regulatory rulemaking process?

Legislation offers two clear advantages over regulation. First, several of the elements of relief discussed above would require changes to existing laws. For example, the examination cycle, fair-lending referral requirements, stress testing requirements and qualified mortgage requirements are set by existing laws. Changing these requirements would therefore necessitate statutory changes.

Second, while it would be possible to provide some relief from the Basel standards through regulations, such relief would be complicated by existing laws. For example, the Federal Deposit Insurance Act requires capital regulations to include a risk-based requirement and a leverage requirement (see Section 38(c)(1)(A)).[2] Therefore, by regulation alone, it would not be possible to implement capital regulations that consisted only of a simple leverage ratio. Additionally, Section 171 of the Dodd-Frank Act subjects banks of all sizes to "generally applicable" leverage ratio capital requirements. If the simple leverage ratio were deemed to be "generally applicable," it would not be possible, through regulation alone, to apply such a ratio only to a limited set of banks that met the criteria discussed above.

7. Among your suggestions for regulatory relief is exempting well-capitalized, traditional banks from all Basel capital standards and associated risk-weighted asset calculations. What specifically do these capital requirement exemptions cover?

Exempting eligible banks from all Basel capital standards would address specific aspects of Basel III including:

- Banks would no longer be required to deduct mortgage service rights from capital.
- Banks that are registered as S-Corporations would not be subject to capital buffers included in Basel III.

[2] https://www.fdic.gov/regulations/laws/rules/1000-4000.html#fdic1000sec.38c

- Banks would not be required to determine specific risk-weights for “high-volatility commercial real estate.”
- Banks would not be subject to numerous methodologies for calculating risk-weights for securitizations products. In addition, this would address certain products (e.g. the FHLB’s MPF program) that are deemed to be securitizations under Basel III.

8. Why do you call for using a tangible equity-to-assets leverage ratio to define eligibility for regulatory relief for traditional banks instead of a risk-based capital ratio? How did you pick 10%?

Our analysis shows that banks with higher leverage ratios prior to the crisis were better positioned to survive the crisis than banks with higher risk-based capital ratios. Studies consistently find leverage ratios to be a strong predictor of default, while also finding little or no value in risk-based ratios.[3] Finally, during the crisis analysts and counterparties assessed banks’ solvency using tangible equity and placed little or no trust in risk-based capital calculations.

The 10% level was chosen for two reasons. First, more than half of the traditional banks currently meet or exceed this level. Roughly half of those that don’t are close (with 9% or more). Second, our analysis show a decline in the rates of failure during the crisis for banks with leverage ratios of 10% or higher[4].

9. Under such an exemption, would available-for-sale securities be counted as trading assets in the capital calculation?

AFS securities would not be counted as trading assets. “Trading assets” as reported on the Call Report generally follows the “Held for Trading” designation under US GAAP. In addition, the Call Report instructions for this field specifically state, “Do not include in this item [i.e. trading assets] the carrying value of any available-for-sale securities . . .”

10. Since the deduction of goodwill from the numerator and denominator is not simple GAAP, has any analysis been done on how this would affect community banks that are undertaking acquisitions?

---

[3] See Adrian Blundell-Wignall and Caroline Roulet, Business Models of Banks, Leverage, and the Distance-to-Default, OECD (2012) available at http://www.oecd.org/finance/BanksBusinessModels.pdf.

[4] Capital ratios and failure rates: https://www.fdic.gov/about/learn/board/hoenig/Failed%20Bank%20Capital%20Ratios%20at%20YE%202007_03%2026%202015.pdf

It is correct that GAAP does not remove goodwill from equity. However, all the necessary amounts (goodwill, total assets and total equity) are GAAP calculations. Our analysis reflects capital levels excluding goodwill, but has not tried to determine the impact on acquisitive banks.

11. If traditional banks are exempted from Basel requirements and measured with a simple leverage ratio as you recommend, what measure would be used in prompt corrective action requirements?

Legislation implementing the changes to capital requirements that I have suggested would have to include amendments to PCA statues, as noted above. This is one of several reasons why I am recommending addressing these issues though legislation, as opposed to making the changes through regulation.

12. From which specific schedules on the call report do you recommend giving traditional banks an exemption?

Schedules RC-D (trading assets and liabilities), parts of RC-L (derivatives) and RC-R (regulatory capital calculations) would serve little or no purpose traditional banks. Other schedules or parts of schedules might also be appropriate for exemptions.

13. What happens to a traditional banking organization that falls below the 10% equity-to-assets ratio requirement to be eligible for streamlined regulation? Would such a bank be required to adopt Basel capital standards and comply with other relevant regulations?

Under this regulatory relief proposal, the banking agencies would be directed to develop a separate prompt corrective action (PCA) standard for banks that meet the criteria. This PCA standard would be the only one applicable to a traditional bank that chose this framework.

With 10% equity-to-assets as the “well capitalized” standard, a traditional bank that fell below this level would be considered “adequately capitalized,” “undercapitalized” or “critically undercapitalized” depending on how far below 10% their capital level was, and how the agencies define these other PCA levels in their regulations.

All of the restrictions that currently apply under PCA standards to banks that are not “well capitalized” – for example, restrictions on brokered-deposits and capital restoration plans – would apply to banks with less than 10% equity-to-assets, as applicable. Importantly, a bank that falls below 10% would not be required to immediately begin complying with the Basel-based PCA framework that would still be applicable to other banks. Rather, because the agencies have long-standing processes for dealing with institutions that have fallen below the well-capitalized level, and these processes would continue to be used under this proposal while the bank continued to operate under the streamlined regulatory framework for traditional banks. Regulators would regularly monitor traditional banks’ capital levels through the examination processes and quarterly call reports.

14. Does your plan apply to bank holding companies? Could one bank affiliate of a holding company meet the qualifying test while another affiliate does not?

As noted above, the plan includes three activity-based tests and one capital test. The activity tests would apply at the bank-level and at the holding company. If they are not met at either level, a bank would not be eligible. For example, a bank that holds no trading assets but that is part of a holding company that has trading activity would not be eligible. As such, it is not possible for one bank affiliate of a holding company to meet the test while another affiliate of the same holding company does not.

15. What is the specific method and timing for measuring whether a bank meets your proposed test for regulatory relief? Would there be an appeals process for banks that are not deemed eligible?

It is possible to determine a bank's eligibility directly from Call Reports and holding company financial reports (if applicable). I have suggested that banks be provided with a 24-month phase-in period to comply with the capital requirement if they do not already do so. Once a bank demonstrates that it meets the requirements by filing its regular reporting forms, it would be eligible for regulatory relief immediately. I have not suggested any specific appeals process, since eligibility should be readily verifiable from existing reports.