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Term-Sheet of Regulatory Relief Recommendations for Commercial Banks
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I. *Background*

Following the recent financial crisis, the Dodd-Frank Act ushered in a series of reforms, many of which were designed in response to the increasing complexity of the industry. For example, over time, the largest commercial banks, which by definition have broad access to the safety net, began to transform into universal banks by expanding beyond commercial banking activities into those activities that were previously reserved for investment banks, wealth managers, insurance companies, commercial and industrial firms and other types of businesses. The expansion of the public safety net to cover investment banking and similar non-commercial banking activities has resulted in a competitive advantage, especially for the large G-SIB banks relative to their smaller regional and community bank counterparts.

The recent regulatory reforms established enhanced prudential standards in part to help constrain the impact of universal banking on the public safety net as well as address the too-big-to-fail concerns that the U.S. G-SIBs pose to our financial system. However, these enhanced standards focused on broad asset-size thresholds to distinguish between those banking organizations that maintain a commercial banking model and those that maintain or are prone to developing into a universal banking model. Banking organizations that fall above one or more of these asset-size thresholds are required to apply the same enhanced regulatory standards regardless of whether the banking organization maintains a commercial banking model or has expanded into universal banking.

However, of the approximately 5,787 commercial banks in the United States, only a small minority have expanded into these non-commercial banking activities. Commercial banks, particularly regional banks, have been placed at a severe competitive disadvantage as a result of being required to apply enhanced regulatory standards that were designed for universal banking organizations. Given the cost and complexity of these enhanced standards, commercial banks, particularly those over the asset-size thresholds, are strongly incentivized to move into universal banking in order to expand their revenue base to offset increased compliance costs and in order to optimize their asset and liability mix so that they can remain competitive and more efficiently apply universal banking standards.

Unless regulatory relief is given to banking organizations with commercial banking models, the future of commercial banking in the United States is in jeopardy. Left unchanged, all large banks in the United States will likely be compelled to adopt the European model of universal banking. This could have a deleterious long-term impact on main street lending and the public safety net. Therefore, regulatory relief would seem to be appropriate for sufficiently capitalized banks predominantly engaged in commercial banking activities, regardless of the size of these institutions.

II. *Statement of Purpose*

The purpose of the following proposal is to encourage the long-term viability of the commercial banks in the United States by ensuring that regulatory requirements are appropriately designed for the commercial banking model without impacting regulatory reforms designed for universal banks and G-SIBs. More specifically, the proposal has been designed to reduce the competitive advantage of universal banks and G-SIBs; promote competition and growth within the commercial banking model; ensure a safe and sound banking system; preserve consumer protections, and restore market discipline.

III. *Applicability and Definition of Commercial Banks*

Commercial Banks that should be eligible for broader regulatory relief could be defined as those with[1]:

1. Total trading assets and trading liabilities of no greater than 10% of Total Assets; and

2. Are not designated as a Global Systemically Important Banking Organization (G-SIB) and are not subsidiaries or affiliates of a G-SIB[2].

Of the approximately 5,787 banks, 99.3% meet the above definition of a commercial bank. Less than 1%, or only about 38 banks, would not meet the two criteria. All but two of these 38 banks, however, are G-SIBs or subsidiaries of G-SIBs and comprise over half (approximately 51.2%) of the total assets held by depository institutions.

IV. *Capitalization*

Historically, commercial banks have been better capitalized than banks engaged in non-commercial bank activities, especially G-SIBs. To acknowledge this fact, and to ensure that regulatory relief does not result in a less safe and sound banking system, and to provide the proper incentives, some simple measure of capitalization should be added to the list of eligibility criteria for regulatory relief.

Thus, in addition to the two definitional criteria above, to be eligible for regulatory relief, a commercial bank should have a ratio of tangible equity to assets (Tangible Equity Ratio as defined below) of at least [8][3] %. As shown in the table below, a significant majority of commercial banks already have a Tangible Equity Ratio of above 8% and many above 10%, a level or a similar threshold that is readily achievable for many more.

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[1] All parent and affiliate banking entities must also meet these requirements; otherwise, the banking organization would not meet the definition of a commercial bank per this proposal and would not be eligible for regulatory relief.

[2] The determination of a "G-SIB" for this purpose should be made consistent with the criteria currently used by the Federal Reserve Board and the Financial Stability Board.

[3] As a general rule, market discipline will require a banking organization to maintain capital in excess of a defined capital requirement in the form of a market-based buffer. If the capital requirement is set at the appropriate level, the market-based buffer should become more robust as the market incorporates the idiosyncratic risk of a particular bank. When establishing a target Tangible Equity Ratio, it is important to incorporate the impact of the market-based buffer and incorporate its impact into the overall capital requirement of an individual bank.

		Percentage of Commercial Banks	Percentage of all banks
Number of banks meeting commercial bank criteria	5,749	100%	99.34%
Of which their Tangible Equity Ratio equals or exceeds:			
8%	5,387	93.70%	93.08%
9%	4,532	78.83%	78.31%
10%	3,400	59.14%	58.75%
11%	2,329	40.51%	40.24%
12%	1,606	27.94%	27.75%

Commercial banks that choose to operate with a Tangible Equity Ratio of [8] % or more would then be eligible for meaningful regulatory relief as described in Section VI. Depending upon the final level of the Tangible Equity Ratio a transition period to achieve it could be made available if necessary.

The Tangible Equity Ratio is calculated as GAAP tangible equity divided by GAAP total assets. In order to derive GAAP tangible equity, goodwill and other intangible assets are excluded from both the numerator and denominator of the ratio. For commercial banks that have derivatives exposure of greater than $8 billion in notional value[4], an adjustment would be made for payment netting[5].

V. *Backstop Provision*

Any banking organization that is determined to be systemically important to the United States economy (in addition to those that meet the G-SIB criteria) would not be defined as a Commercial Bank. The circumstances around the use of the provision would be expected to be rare and is designed to prevent arbitrage of the purpose and intent of the framework:

- Such a determination shall be made jointly by the Federal banking agencies through a notice and comment rulemaking process. In determining whether a banking organization is systemically important to the United States economy, such determination shall not be primarily based on the size of a banking organization's on-balance sheet assets, insured deposits, retail lending activities, wholesale lending

[4] Exposure includes both cleared and non-cleared derivatives.
[5] The payment netting adjustment is calculated as the difference between gross derivative assets and the amount of derivative assets reported on the balance sheet; both amounts of which are reported in the financial statements and on the current Call Report. This adjustment would result in only allowing the recognition of derivatives netting where the bank and its counterparty actually net the derivatives payments to one another. It would not recognize "close-out netting", where both parties must make a gross (non-netted) payment to each other and can only net the payment when one party defaults. It is necessary to limit derivatives netting to only payment netting to more fully account for the market risk, counterparty credit risk and liquidity risk associated with derivatives transactions. Approximately 27 banks that meet the commercial bank criteria would be required to include a payment netting adjustment in the Tangible Equity Ratio calculation. A Commercial Bank could manage down this adjustment by entering into contracts that require payment netting and which reduces liquidity demands for both the bank and its counterparty and promotes financial resilience.

activities, or other such activities traditionally considered essential to commercial banking.

VI. *Regulatory Relief*

Dialogue with commercial banks of all sizes consistently highlights several areas that are the source of concern with respect to regulatory burden. These areas include, but are not necessarily limited to, the new risk-based capital and liquidity rules, an ever-expanding Call Report, the costs of mandated stress testing and living wills, appraisal requirements, and the frequency of the examination cycle.

Community banks on their own are not expressing major complaints involving other areas of regulation, including the supplementary leverage ratio, derivatives clearing requirements, increased margin requirements, which all predominantly impact the largest banks and the GSIBs. However, in general the regulatory burden for commercial banks from these rules is modest.

As such, meaningful regulatory relief for commercial banks (i.e. those that meet the two definitional criteria and choose to have an equity to assets ratio of [8] % or higher) can be provided in a manner that is entirely consistent with safety and soundness and preserves important consumer protections. Such relief could include, but not necessarily be limited to, the following:

- Exempt commercial banks from all Basel capital standards and associated capital amount calculations and risk-weighted asset calculations.
- Exempt commercial banks from the quantitative liquidity standards such as the LCR and the modified LCR.
- Exempt commercial banks from several entire schedules on the Call Report, including schedules related to trading assets and liabilities, regulatory capital requirement calculations, and derivatives.
- Exempt commercial banks, if applicable, from CCAR and stress testing requirements under section 165(i)(2) of the Dodd-Frank Act.
- Exempt commercial banks from submitting living wills (or expand the frequency of the exercise to every 3 or 5 years).
- Eliminate requirements to refer "possible fair lending violations to Justice" if judged to be de minimis or inadvertent.
- Establish criteria that would exempt commercial banks from appraisal requirements.
- Require only an 18 month examination cycle as opposed to a 12 month cycle for commercial banks.

While commercial banks would remain subject to the Volcker Rule the following modifications should be considered:

1. A commercial bank would be granted a regulatory safe harbor whereby they would be presumed compliant with the proprietary trading restrictions of the Volcker Rule and not be required to demonstrate compliance on an on-going basis provided the bank meets the requirements for a commercial bank and the following additional criteria:
    - Does not have trading assets and trading liabilities other than exposures to the US government or an agency of the US government; US State and municipalities; government sponsored enterprises (GSEs); and asset-backed securities guaranteed by, or comprised of exposures guaranteed by, the preceding entities; and derivatives exposures; and,
    - All derivative exposures, including those included in the bank's trading assets and liabilities are limited to those that meet GAAP hedge accounting standards, or are issued in conjunction with a loan.

2. A commercial bank would be allowed to invest up to 3% of its GAAP equity in funds that would otherwise be defined as a "Covered Fund" under the Volcker Rule provided the following conditions are met:
    - The Covered Fund invests primarily in common or preferred equity shares of portfolio companies;
    - The Covered Fund's investments in the portfolio companies are intended as long-term investments by the fund at the time of purchase;
    - Any asset holdings of the fund other than common or preferred equity shares are for the sole purpose of the furtherance of long-term investment strategies, consistent with proper liquidity management, or for prudent hedging of interest rate or foreign exchange risks;
    - The commercial bank does not hold more than 3% of the economic interests of any single fund; and,
    - If the commercial bank also sponsors or manages Covered Funds and is subject to the current 3% of capital limitation under the Volcker Rule, its investments in the funds described above also are included in the existing 3% of capital limitation.

VII. Conclusion

This approach to regulatory relief provides a beneficial and prudent trade-off for banks by incentivizing commercial banking activities. If a bank sticks to commercial banking activities and conducts its activities in a safe and sound manner with sufficient capital, it will have less regulatory burden. On the other hand, if a bank elects to expand its activities into non-commercial bank areas and to use the subsidies that arise from the bank's access to the safety net to fund these activities, such a bank must accept additional regulatory burden to protect the safety net.