American Bankers Association

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By Email

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Interim Final Basel III Capital Rule

To Whom It May Concern:

The American Bankers Association[1] (ABA) is pleased to submit comments on the interim final Basel III capital rule (Interim Rule)[2] published by the Federal Deposit Insurance Corporation (FDIC).

The Interim Rule is the latest step in the FDIC's implementation of the Basel III capital standards. In the wake of the financial crisis the FDIC, Office of the Comptroller of the Currency, and Federal Reserve Board (the Agencies) worked with the Basel Committee to develop international capital standards. In 2011, the Basel Committee finalized its Basel III Accord (Basel Accord).[3] In June 2012, the Agencies issued notices of proposed rulemakings implementing the Basel Accord in the U.S.[4] The proposals, by which the Agencies planned to extend the Basel Accord to all U.S. banks, represented a comprehensive overhaul of the U.S. bank capital framework. ABA, and the industry as a whole, commented extensively on the proposed rules.[5]

Although there were many significant changes from the original proposal in the Interim Rule, ABA believes that the Interim Rule still does not create a regulatory capital framework that fits the U.S. banking industry and economy well. As a result, the Interim Rule will likely hinder

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[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its 2 million employees. Learn more at www.aba.com.
[2] 78 Fed Reg 55340 (September 10, 2013).
[3] See, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Revised June 2011), available at http://www.bis.org/publ/bcbs189.pdf.
[4] The three proposals were (i) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012); (ii) Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements 77 Fed. Reg. 52,888 (Aug. 30, 2012); and (iii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule, 77 Fed. Reg. 52,978 (Aug. 30, 2012).
[5] ABA comment letter is available at http://www.aba.com/Press/Documents/ABASIFMAFSRBankCapitalProposalLetter.pdf

credit availability, dampen economic growth, and harm the competitiveness of the U.S. banking system and the U.S. financial sector.

ABA believes that the Interim Rule would have been better crafted and thus more effective and better matched to the U.S. financial sector if the process for developing international standards were more robust and transparent. Prior to negotiating international standards, and throughout the development process, the Agencies should more fully understand the implications for the U.S. banking sector and the U.S. economy as a whole of the elements and the concepts involved in the provisions under consideration. The process for developing international standards needs to be improved, particularly to provide more accountability and more transparency. Specifically, ABA recommends:

- No later than the same time that the Basel Committee issues a consultative document, the Agencies issue a related and detailed Advance Notice of Proposed Rulemaking (ANPR) domestically that clearly presents to the public the scope and objectives of any U.S. participation in discussions and negotiations connected with the Basel Committee's consultative document; and;

- The Agencies conduct an empirical study of the impact on the U.S. banking system and bank customers in particular and the economy in general resulting from the adoption of the proposed international standards being considered.

ABA notes that many community and midsize banks are frustrated with the United States' participation in the Basel Committee. These frustrations stem from the fact that even though Basel standards are held out to be designed and intended for large, internationally active banks, U.S. regulators are increasingly applying them to even the smallest banks. A better public process that specifically considers the impact on the entire U.S. banking community and its customers as well as on the economy would result in better rules that are less likely to be a bad fit for the U.S. economy and its diverse banking sector.

Improving the process by issuing an ANPR would be consistent with past practice. In 2003, during the development of the Basel II standards the Agencies issued an ANPR that clearly outlined scope, potential regulatory requirements, and asked for comments so the Agencies could "seek appropriate modifications" at the international level. As a result of the Basel II ANPR, every bank knew whether the Basel process would affect them and with that information could decide whether to participate in the comment process. It also led to the development of a more calibrated approach for the U.S., with various options better adapted to the variety in size, complexity, and business models of U.S. banks.

ABA also notes, notwithstanding the fundamental changes introduced by the adoption of the Basel Accord and its broad scope of application, the Agencies presented only limited cost-benefit or other quantitative analysis for the adoption. ABA urges that during the phase-in period the FDIC, with the other agencies, perform, publish, and invite comments on a comprehensive empirical study of the Interim Rule, focusing on key areas such as the ones we address later in this letter that represent significant changes to current regulatory capital measurement with real impact on the banking industry and its ability to serve its customers. Such an empirical study would help the Agencies assess whether aspects of the proposals are desirable in view of their impact on the provision of credit and other financial services by all types of U.S. banking organizations and on the U.S. economy, as well as their effect on important indicators of challenge to industry competitiveness—for example, increased industry consolidation.

Conducting a study on proposed Basel standards and consulting with the entire banking sector earlier in the process would have led to better rules. Certain aspects of the Interim Rule, which is based on the Basel Accord, still do not fit the U.S. banking sector.

We encourage the FDIC, and other banking agencies, to make further needed changes to the rules during the phase in-period. These changes include:

- Allowing banks that have elected Subchapter S tax status to distribute an amount that is equal to the tax due on the S-Corp's income, thus equalizing the tax treatment allowed for C-Corp banks;
- Increasing the Mortgage Servicing Asset (MSA) deduction threshold from ten to twenty-five percent of common equity tier 1 (CET1) and eliminating MSAs from the fifteen percent aggregate deduction;
- Grandfathering the Basel I capital treatment of existing Trust Preferred Security (TruPS) investments;
- Giving all banks the option to filter unrealized gains and losses; and,
- Maintaining the Basel I treatment of delinquent loans.

Although the risk-based standards can be improved, they remain an important way of gauging and guarding against the actual, identifiable risks associated with a particular bank, which service cannot be provide by a one-dimensional risk-blind leverage ratio. We encourage the Agencies to focus their efforts in improving the risk-based standards as suggested in this letter before developing new leverage ratio requirements.

The Interim Rule's capital conservation buffer requirement places community banks electing Sub Chapter S federal tax status at a competitive disadvantage.

We continue to have concerns that the capital conservation buffer provisions of the Interim Rule will seriously and inappropriately disadvantage the over 2,000 U.S. community banks that have elected Subchapter S tax status (S-Corp banks). Under the Subchapter S rules, shareholders are required to pay federal income taxes on a firm's profits proportionate to the shareholders' ownership interest in the company – regardless of whether profits are distributed to the shareholders. Generally, shareholders are able to meet their tax obligations from distributions they receive from the S-Corp Bank. However, under the capital conservation buffer requirements of the Interim Rule, a bank may be limited or prohibited from making distributions if the bank's capital levels fall below the required capital buffer even though the bank is profitable and lively enough to incur a tax liability.[6] In such a case, the tax obligation would

[6] 78 Fed. Reg. 55340 (September 10, 2013) at 55488 (Section 324.11).

remain, forcing the bank's shareholders to pay taxes on income that they have not received and placing the S-Corp bank at a competitive disadvantage to C-Corp institutions.

To illustrate the problem, assume that a bank has taxable income of $1,000,000, and its capital is below the conservation buffer limitation. Neither a C-Corp nor an S-Corp is allowed to make distributions to shareholders, even though taxes are due on the bank's income. If the bank is a C-Corp, the bank would remit $340,000 to the U.S. government to pay its federal taxes. If the bank is an S-Corp, the shareholders, rather than the bank, would be required to remit approximately the same $340,000 to the U.S. government to pay federal taxes. Because the capital conservation buffer rule does not allow distributions – even for the purpose of paying federal income tax[7] – the S-Corp shareholders are forced to pay these taxes themselves whereas had they been C-Corp investors they would have no such tax liability.

The above example demonstrates that, effectively, a distribution is allowed to be made from the C-Corp profits to meet tax obligations, but no similar tax payment is made by the S-Corp. This result will create a powerful disincentive for investment in community banks that have elected Subchapter S status, critically harming the growth and perhaps even viability of S-Corp community banks, especially in times of economic stress, and frustrating the purpose of Congress in creating the S-Corp category to stimulate investment in small businesses.

This posture also undermines safety and soundness purposes. Community banks, and S-Corp banks in particular, are already disadvantaged with respect to capital-raising avenues. The same shareholders that are required to pay taxes on income not received are the shareholders that will likely be called upon to provide the additional capital to boost the capital conservation buffer. In effect, the existing investors will be asked to add to the capital of the bank and increase their uncovered tax liability. It is not hard to see the difficulty in persuading such investors.

This disadvantage can be easily addressed by allowing S-Corp banks to make distributions for the limited purpose of allowing shareholders to make tax payments on their share of the S-Corp bank's undistributed income in an amount equal to the effective tax rate for C-Corps. Hence, an S-Corp should be allowed to distribute an amount that is equal to the tax due on the S-Corp's income, so that the S-Corp is not placed at a disadvantage compared to a C-Corp. This would put the S-Corp banks on the same footing as C-Corp banks whose taxes are paid regardless of whether there is a restriction on dividend distributions. And it would preserve just as much of the bank's profits as retained earnings as would be the case were the bank a C-Corp entity.

The treatment of mortgage servicing assets under the Interim Rule remains punitive and places a significant burden on banks that service residential mortgages.

Under the Interim Rule, MSAs includable in regulatory capital decrease from 100 percent of Tier 1 capital to 10 percent of CET1—a significantly narrower category of capital than Tier 1. The Interim Rule also imposes an overall limitation of 15 percent of CET1 on the combined balance of includable MSAs, deferred tax assets, and investments in the common stock of unconsolidated financial institutions. Finally, MSAs that are not deducted from CET1 are subject to a 250 percent risk weight. Although the Interim Rule does remove the 10 percent haircut on the fair

[7] 78 Fed. Reg. 55340 (September 10, 2013) at 55354

market value of MSAs imposed by Section 475 of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the Interim Rule's treatment of MSAs places broad constraints on MSAs which will lead to a significant reduction in the retail mortgage servicing operations of banks, particularly community, midsize, and regional banks.

Servicing mortgage loans is a specialty of many banks and has provided a strong source of fee income for decades. For even more banks, particularly community, midsize, and regional institutions, mortgage servicing is an important way to maintain valuable long-term customer relationship, while allowing the bank to sell a long term asset to manage its interest rate risk. The treatment of MSAs under Basel III has already caused some banks to sell more mortgages servicing-released to the mortgage purchaser placing customer relationships at risk. In addition, since all banks are subject to these restrictions it is likely that overtime, a larger portion of the mortgage servicing business will migrate to non-bank mortgage servicers, a shift of market share that we do not believe is intended by the Agencies. Customers and the long term relationships that they have built with banks they have chosen to do business with should not be penalized by the Interim Rule's punitive MSA capital treatment.

To avoid these adverse consequences, we recommend that the MSA deduction threshold be increased from ten to twenty-five percent of CET1, and MSAs should be eliminated from the fifteen percent aggregate deduction. A twenty-five percent reduction, although still a significant restriction compared to previous capital treatment, would lessen the disruption to customers and the relationships that they have chosen to build with their bank.

The Interim Rule's deduction of trust preferred securities (TruPS) CDOs will harm U.S. banks.

Smaller banking organizations historically have had more difficulty than their larger counterparts in accessing the capital markets through the issuance of capital instruments. TruPS collateralized debt obligations (CDOs) provided a means for smaller banking organizations, which may have been too small to access capital markets directly, to issue TruPS that were pooled into CDOs and sold into debt markets. Because of the community bank nature of TruPS, we do not believe the Basel Committee considered the impact on these instruments as part of its deliberative process.

Banking organizations can be issuers and/or investors of TruPS. On the issuing side, congressional action has eliminated TruPS as a permitted tier 1 capital instrument for banks above $15 billion. Matching what is expressly permitted by the Dodd-Frank Act, for banks below $15 billion, the Interim Rule grandfathers these securities as tier 1 capital instruments. On the investing side, these instruments are subject to the corresponding deduction method under the Interim Rule.

ABA believes the corresponding deduction fails to address effectively TruPS CDO investments held by a banking organization. Under the rules for regulatory capital adjustments in the Interim Rule, a bank must take a corresponding deduction from the component of capital for which the underlying instrument would qualify. For example, if the issuer counted the instrument as tier 1, then the investor should deduct from tier 1 capital. If the issuer counted the instrument as tier 2 capital, then the investor should deduct from tier 2 capital. Not only is this treatment severe, it is also extremely complex. The TruPS underlying a TruPS CDO may include a large number of separate issuers, potentially subject to different phase-out schedules.

Given the significant impact this aspect of the Interim Rule will have on institutions holding TruPS as investments, and the complexity of the TruPS CDO treatment, ABA strongly urges the FDIC to amend the Interim Rule to grandfather the existing capital treatment for TruPS investments that were originated before the effective date of the final regulation. Such grandfathering of legacy TruPS would alleviate the operational burdens and data constraints on banking organizations. Grandfathering would also make the transition to the new rules much more manageable and reasonable as existing loans are paid off over time.

Unrealized gains and losses should not flow through to capital for any U.S. banking organization.

Under the Interim Rule, banking organizations subject to the advanced approaches risk-based capital standards (Advanced Approaches Banks) are required to "flow through" to CET1 all unrealized gains and losses from a banking organization's available for sale (AFS) portfolio.[8] We continue to believe strongly that these unrealized gains and losses should not be taken into account in any banking organization's capital calculation, no matter the size of an institution. Including such unrealized gains and losses in capital will add substantial volatility into the capital calculation, create balance sheet distortions, and undermine prudent risk management techniques at the nation's largest banks, including discouraging Advance Approaches Banks from holding high-quality liquid assets, contrary to the newly proposed liquidity rules applicable to those organizations. By that same process, this will add volatility to the broader economy, reducing the important role that banks have played in moderating the ups and downs of the business cycle.

The debt securities generally held in AFS portfolios are highly liquid bonds, such as U.S. Treasuries, the value of which is primarily impacted by changes in interest rates. Therefore, in a rising rate environment, the value of those securities will decrease, creating volatility in the capital calculation on a temporary basis, since generally unrealized loss reflected in a bank's AFS portfolio is likely only temporary in nature and will never be realized if a bank holds those securities to maturity. To take into account the volatility now introduced into capital calculations, Advanced Approaches Banks will hold "volatility buffers" above any set regulatory capital levels. Setting aside the capital above the regulatory requirements that could otherwise be used to meet the needs of the nation's consumers and corporations adds permanent inefficiency into the nation's capital markets, a lasting drag on national economic growth. This will be further exacerbated for these institutions if unrealized gains and losses are taken into account in calculating the supplementary leverage ratio, placing a significant restraint on their ability to serve as the nation's largest financial intermediaries.

In addition, all banks generally match their assets with their liabilities to manage interest rate risk. Unrealized losses in the AFS portfolio are likely offset by gains from other assets or liabilities on a bank's balance sheet. That offset does not flow through capital, resulting

[8] 78 Fed. Reg. 55340 (September 10, 2013) at 55348.

potentially in an overstatement of the amount of capital an impacted bank may need to absorb economic losses. For example, in a rising interest rate environment, flow through of unrealized gains and losses to capital could decrease a bank's capital, even though the value and profitability of a bank may have increased.

Moreover, we continue to be concerned that requiring unrealized gains and losses from an Advanced Approaches Bank's AFS securities portfolio to flow through to capital will undermine prudent risk management at the nation's largest institutions. For example, banks may shorten the maturity of their AFS portfolio to manage the volatility of their capital ratios created by the proposal. Shortening maturities in their AFS portfolio could result in maturity mismatches potentially increasing the impact of rising interest rates. A bank may also move a substantial portion of its AFS portfolio to the held to maturity category, which would limit its ability to respond to a liquidity event, which result would conflict with the purpose of the recently proposed liquidity rules for these institutions. Hampering the largest banks' ability to manage these risks will only weaken their ability to meet the needs of the market, slowing economic growth.

Finally, we are concerned that requiring the flow through of unrealized gains and losses into capital calculations will place the U.S. banking sector at a competitive disadvantage internationally. We note that other jurisdictions that have previously agreed to this treatment as part of the Basel III negotiations are now contemplating at least a delay in the implementation of this requirement. If European institutions are provided a reprieve, U.S. institutions will be disadvantaged, at least temporarily. Therefore, we urge reconsideration of the decision to require Advanced Approaches Banks to flow through unrealized gains and losses to capital.

The Interim Rule treatment of delinquent loans is inappropriate.

The Interim Rule assigns a 150 percent risk weight to a non-mortgage exposure that is 90 days or more past due or on nonaccrual (and that is not guaranteed, not secured, not a sovereign exposure, and not a residential mortgage exposure). This treatment is inappropriate, because it ignores (i) the independent requirement to increase loss reserves for past due loans, and (ii) the required full deduction from capital for certain of those increased loss reserves.

Banking organizations increase loan loss reserves when loans become delinquent, independent of risk-based capital standards, and external auditors and agency examiners carefully review such increased provisioning to ensure that loan loss reserves are adequate. Such increases in reserves effectively increase the loss-absorption capacity of the banking organization in the same way as increased capital. Thus, requiring higher risk weights for past due loans, which at the margin would result in higher capital for such loans, effectively results in a kind of double-counting of the increased loss-absorption capacity already resulting from provisions to loan loss reserves for the very same loans. Moreover, loan loss reserves exceeding 1.25 percent of standardized assets are separately required to be deducted from Tier 2 capital. Requiring higher risk weights for delinquent loans while at the same time deducting from capital the provisions associated with such loans results in an even greater degree of double-counting.

This double-counting amplifies the pro-cyclicality of the banking industry by requiring more capital and accelerating the contraction of credit during times when credit is needed the most. We urge the FDIC to amend the Interim Rule so that the risk-weights remain constant in the event of delinquency.

Thank you for considering the concerns raised in this letter. We appreciate the opportunity to share our views and would be happy to discuss any of them further at your convenience.

If you have any questions, please contact Hugh Carney, Senior Counsel, of ABA at (202) 663-5324 (e-mail: hcarney@aba.com).

Sincerely,

Hugh C Carney

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