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January 22, 2019

Ms. Jelena McWilliams, Chairman
Federal Deposit Insurance

Mr. Joseph M. Otting
Comptroller of the Currency

Mr. Jerome H. Powell, Chairman
Federal Reserve System

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

Re: Comments (RIN 3064-AE98)
Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations

Dear Ms. McWilliams, Mr. Otting, and Mr. Powell,

The purpose of this letter is to comment on the Notice of Proposed Rulemaking ("NPR") for Capital Simplification for Qualifying Community Banking Organizations published by the Department of Treasury, Office of the Comptroller of the Currency (OCC); Federal Reserve System (Board), and Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies).

Sandler O'Neill + Partners, L.P. is a market-leading, full-service investment banking firm and broker-dealer focused on the financial services sector.[1] Our clients include over a thousand banks and thrifts and their holding companies (together, "banks"). This letter has been prepared by experienced practitioners in the financial sector at a 30-year-old firm that, with its clients, have navigated several periods of crisis and several rounds of regulatory reform. Last

[1] For further information on Sandler O'Neill, please see http://www.sandleroneill.com/.

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year, we advised on more bank M&A deals than any other firm in the U.S.[2] and we have consistently been among the top advisors for debt and equity capital raising for U.S. banks and their holding companies.

In the NPR, the Agencies reference the considerations they weighed in designing the Community Bank Leverage Ratio (CBLR) framework. These include:

- "First, the CBLR framework is intended to be available to a meaningful number of well capitalized banking organizations with less than $10 billion in total consolidated assets.
- Second, the CBLR should be calibrated to not reduce the amount of capital currently held by qualifying community banking organizations.
- Third, the agencies intend for banking organizations with higher risk profiles to remain subject to the generally applicable capital requirements to ensure that such banking organizations hold capital commensurate with the risk of their exposures and activities.
- Fourth, consistent with the Act, the agencies would maintain the supervisory actions applicable under the PCA framework and other statutes and regulations based on the capital ratios and risk profile of a banking organization.
- Finally, the CBLR framework is intended to provide meaningful regulatory compliance burden relief and be relatively simple for banking organizations to implement."[3]

Among others, the NPR poses the following questions:

Question 9: *What changes, if any, would commenters suggest to the proposed definition of CBLR tangible equity?* [4]

Question 18: *What other factors should the agencies consider in calibrating the CBLR and why?* [5]

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[2] S&P Global Market Intelligence January 1, 2018 – December 31, 2018

[3] Department of the Treasury (Office of the Comptroller of the Currency), Federal Reserve System, Federal Deposit Insurance Corporation. Notice of Proposed Rulemaking for Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations. November 20, 2018. Page 12.

[4] Department of the Treasury (Office of the Comptroller of the Currency), Federal Reserve System, Federal Deposit Insurance Corporation. Notice of Proposed Rulemaking for Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations. November 20, 2018. Page 26.

[5] Department of the Treasury (Office of the Comptroller of the Currency), Federal Reserve System, Federal Deposit Insurance Corporation. Notice of Proposed Rulemaking for Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations. November 20, 2018. Pages 18 -19.

In response to these questions, we suggest two changes to the definition of the CBLR that should improve the marketability of CBLR-eligible preferred stock and broaden the base of community banks that qualify to use the CBLR:

1. Include cumulative preferred with a stated final maturity date as an eligible component of CBLR tangible equity:

   The current market for preferred stocks issued by financial institutions is overwhelmingly comprised of non-cumulative perpetual preferred securities issued by larger, highly-rated companies. Generally investors (equity or fixed income) will eschew an investment whose issuer has little or no incentive to pay its dividend or return principal. Investors are willing to buy preferred stock issued by public companies because they assume the public companies will treat investors fairly lest they lose access to public markets. Further, this type of issue is generally exchange-traded, offering on-demand liquidity to investors. As a result, larger public issuers can often issue preferred stock at a cost of capital significantly lower than required when issuing common equity. A cumulative dividend might incent investors to purchase offerings of smaller institutions, but without a stated final maturity date, issuers could accrue unpaid dividends cumulatively with little consequence or reckoning and, absent public trading, no opportunity for liquidity. Adding a stated final maturity date would likely attract a wide range of fixed income investors, thus reducing the cost of capital and ultimately aiding the Agencies in their stated goals. We certainly appreciate that tangible equity must be loss absorbing. The inclusion of a stated final maturity for cumulative preferred stock does not impact the loss absorbing capacity of the capital but will significantly expand the market of potential investors and, therefore, lower the cost of capital to issuers.

2. Reduce the CBLR requirement from 9% to 8%:

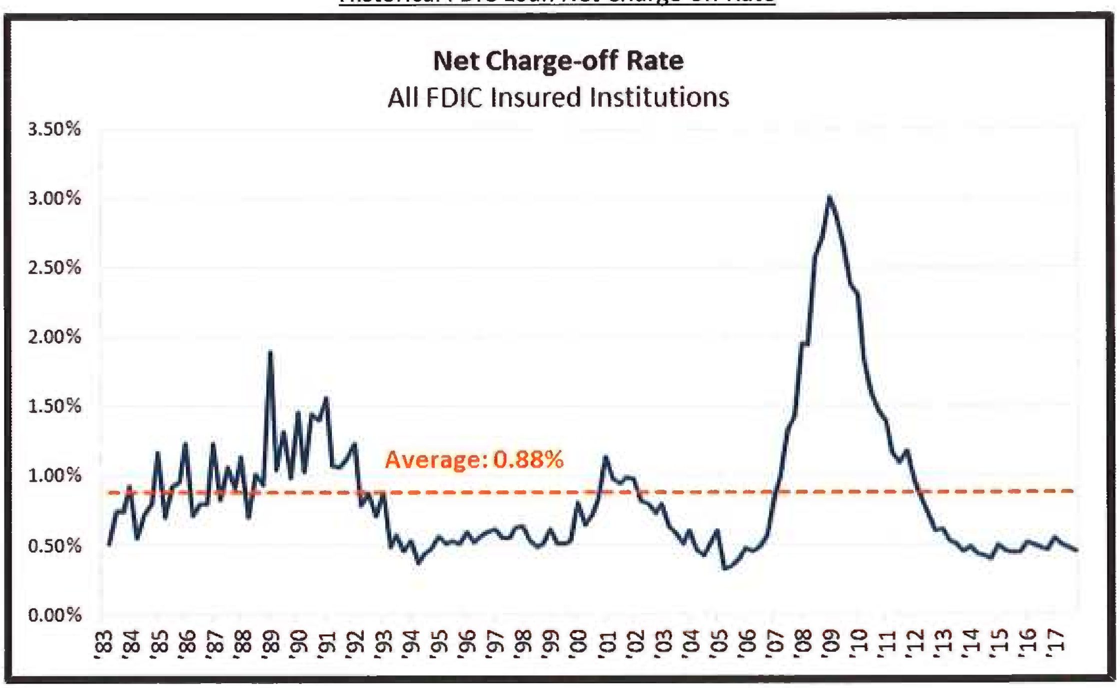
   The 9% TE/TA proposed CBLR threshold was set in order to offer a simple capital ratio that was broadly available to well-capitalized community banks. As demonstrated below this level is prohibitive to a majority of targeted banks, neglects the impact of the CECL charge, does not factor in the "stranded" adjusted allowance for credit loss (AACL) for up to 1.25% of risk weighted assets that will not be included in CBLR tangible equity but would be included in Basel III, and does not consider the much lower level of current qualification for banks with $3 billion or more in assets but less than $10 billion.

a. CECL charge: The proposed 9% threshold did not consider the need to maintain a buffer to avoid falling below well-capitalized with the implementation of ASC 842 in 2019 and CECL beginning in 2020. These accounting changes will bring capital volatility and require banking organizations to maintain a buffer above the stated requirement. With the 9% requirement for the CBLR plus a buffer of 50 to 100 BP to provide for potential CECL and ASC 842 accounting charges, the effective requirement would be 9.5% to 10% to remain well capitalized.

To put this capital buffer into perspective and determine a high-level estimate of the potential CECL charge for the industry, we examined FDIC loan loss data back to 1984 to calculate an annualized long-term average net charge off rate (NCO) rate of 0.88% (see chart A below).

Chart A

Historical FDIC Loan Net Charge-off Rate



Source: FDIC, Sandler O'Neill

We further assumed 3.5 years weighted average life for total industry loans to calculate a cumulative expected net charge off rate on average loans of 3.08%. By applying this loss rate to the industry average loans of almost $10 trillion at June 30, 2018, we determined the pro forma expected required reserves to be $301 billion. With current reserves of $123 billion, **the required reserves would be an additional $178 billion ($141 billion after-tax)**. The tax-effected charge from CECL would lower the industry TE/TA ratio from 9.29% to roughly 8.54% representing a drop of about 75 basis points in tangible equity. Pro forma reserves to loans would be increased about 181 bps to roughly 3.06%. See Chart B below for details. Of course, the actual CECL charge for any particular bank will vary based on that institution's loan mix, loss history and life of loan among other factors.

Chart B

Estimated Industry CECL

As of 2Q 2018 — **Amounts in Millions of USD**

Assumptions				
Long Term Average NCO Rate	0.88% **(a)**			
Assumed Average Life of Loans	3.5 yrs **(b)**			
Expected Losses on Average Loans	3.08% **(a x b)**			
Change in Reserves under CECL	**Current**	**Pro Forma**	**Change**	
Total Average Loans	$ 9,794,371	$ 9,794,371		
Total Reserves	$ 123,420	$ 301,429	$ 178,008	
		Assumed Tax Rate	21%	
		After Tax Impact to Equity and Assets	$ 140,627	
Pro Forma Capital and Reserves under CECL	**Current**	**Pro Forma**	**Impact**	
Tangible Equity	$ 1,592,016	$ 1,451,390		
Tangible Assets	$ 17,141,055	$ 17,000,428		
Tangible Equity/ Tangible Assets	9.29%	8.54%	**(75) bps**	
Reserves/ Loans	1.25%	3.06%	**181 bps**	

Source: FDIC, Sandler O'Neill
Note: Bank level data

Chart C below shows the impact on banking industry tangible equity/tangible assets ratios from varying the level of NCO from 20 bps to 140 bps per year and average loan life from one to five years. With the base case assumption of 88 bps NCOs and 3.5 year average life, the decline in TE/TA ratio is roughly 75 bps. Note that the loss assumption is highly sensitive to assumed average loan life.

With the same charge-off rate of 88 bps, a reduction in average loan life from 3.5 to 2 years would cause the TE/TA ratio to decline about 75 bps to 20 bps. As such, banks will have an incentive to shorten average loan life going forward to lessen the impact of CECL. The change in the range of potential loss from CECL based on variance in assumptions reinforces the need for banking institutions to provide a capital cushion when developing a plan for capital needs from 2019 and to have a lower starting CBLR ratio of 8%.

Chart C

CECL Potential Impact to Tangible Equity/Tangible Assets Ratio (bps)

	NCO Rate						
Average Loan Life	0.20%	0.40%	0.60%	0.88%	1.00%	1.20%	1.40%
1.0	43	35	27	16	11	2	(6)
1.5	39	27	15	(2)	(10)	(22)	(35)
2.0	35	19	2	(20)	(30)	(47)	(63)
2.5	31	11	(10)	(39)	(51)	(72)	(93)
3.0	27	2	(22)	(57)	(72)	(97)	(122)
3.5	23	(6)	(35)	(75)	(93)	(122)	(152)
4.0	19	(14)	(47)	(93)	(114)	(147)	(181)
4.5	15	(22)	(59)	(112)	(135)	(173)	(211)
5.0	11	(30)	(72)	(130)	(156)	(198)	(241)

It is obvious that the Agencies are concerned about the impact of CECL charges on regulatory capital ratios, as they intend to allow banks to amortize their CECL charge over 3 years for regulatory capital purposes. However, amortizing the charge for regulatory capital purposes does not lessen the upfront charge for GAAP capital purposes and the performance measurement and valuation of banking organizations are based on GAAP accounting. Banking organizations that adopt the CBLR at 9.0% (plus a buffer to account for CECL and ASC 842), will be required to have a much higher tangible equity base and, as a result, will show underperformance relative to their peers that use the Basel III capital framework. As explained below, the additional CECL charge will at least count towards additional tier 2 capital under Basel III but will receive no credit towards well-capitalized status under the CBLR.

b. <u>"Stranded" AACL Allowances</u>: No benefit for adjusted allowance for credit losses: With the adoption of the CBLR, banking organizations no longer need tier 2 capital. Therefore, any credit for AACL for up to 1.25% of risk-weighted assets does not help with meeting well-capitalized requirements for the CBLR.

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c. Many fewer banks qualified at $3 to $10 billion in assets: The BHCs with less than $3 billion in assets already have the small BHC policy statement to provide regulatory capital flexibility. The banks between $3 billion and $10 billion in assets can only use Basel III or the CBLR for their capital regime. As shown below in Chart D, for insured depository institutions with less than $3 billion in assets, we estimate that 81% qualified to use the CBLR at 9% TE/TA, 62% qualified to use the CBLR at 10%, and 45% qualified at 11%.

Alternatively, 93% would qualify if the CBLR was lowered to 8%. For the larger insured depository institutions with $3 billion or more in assets but less than $10 billion, **we estimate that only 66% qualified to use the CBLR at 9% TE/TA, 43% qualified to use the CBLR at 10%, and 27% qualified at 11%**. But 81% of the larger banks would qualify to use the CBLR if the base was lowered to 8%. This means that many fewer banks in this size range would qualify to use the CBLR if they factor in a capital cushion above the 9% threshold and likely one of the reasons that the Independent Community Bankers of America have advocated that the CBLR base should be set at 8% rather than 9%.

Chart D

CBLR Qualification Sensitivity from 9% to 11% TE/TA

Insured Depositories < $3B

		CBLR TE/TA (%)					
Total Institutions	CBLR Eligible	≥ 8.0	≥ 9.0	≥ 9.5	≥ 10.0	≥ 10.5	≥ 11.0
5,274	**5,121**	**4,928**	**4,292**	**3,783**	**3,290**	**2,799**	**2,377**
100%	97%	93%	81%	72%	62%	53%	45%

Insured Depositories ≥ $3B < $10B

		CBLR TE/TA (%)					
Total Institutions	CBLR Eligible	≥ 8.0	≥ 9.0	≥ 9.5	≥ 10.0	≥ 10.5	≥ 11.0
185	**161**	**149**	**122**	**102**	**80**	**58**	**50**
100%	87%	81%	66%	55%	43%	31%	27%

Source: S&P Global Market Intelligence as of June 30, 2018, CBLR NPR (bank level depository institutions)

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The CBLR capital framework may be attractive to some banking organizations with less than $10 billion in assets. In this letter, we have recommended adjustments to the definition to tangible equity and qualifications for community banks that will greatly enhance the marketability of preferred stock at a lower cost of capital and dramatically increase the number of well-capitalized community banks that would qualify to use the CBLR framework.

We appreciate your consideration of our comments and would welcome the opportunity to discuss these further with you or respond to any questions as the Board finalizes the CBLR rules.

Respectfully submitted,

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