New York Bankers Association
99 Park Avenue
New York, NY 10016-1502
212.297.1699 Fax 212.297.1658
msmith@nyba.com

Michael P. Smith
President and CEO

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Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
Delivered via email regs.comments@federalreserve.gov

Robert E. Feldman
Executive Secretary Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
Delivered via email comments@FDIC.gov

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
Delivered via email regs.comments@occ.treas.gov

Re; Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Basel III and Standardized approach Notices of Proposed Rulemaking that were recently proposed by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "Agencies") and which make substantial revisions to banks' risk-based capital rules. While the New York Bankers Association (NYBA) understands and supports the goals of these proposals, (i.e., to ensure that banks are well-capitalized and that bank capital is of a high quality), we believe that these extremely complex proposed regulations would result in an array of unintended negative consequences, including less credit availability for consumers, a less vibrant banking system, and a damaged American economy. We also believe that these rules would place United States banks at a significant disadvantage to our global competitors. NYBA is comprised of the regional, community and money center commercial banks and thrift institutions in New York. Its members have aggregate assets in excess of $11 trillion and more than 200,000 New York employees.

At the outset, it is important to note that the capital requirements of Basel III were designed with large domestic and foreign banking institutions in mind. Yet, the current proposals would apply – with few exceptions – to most banks in the United States, and create, we believe, substantial harm, most particularly, to the thousands of community banks nationwide. This is so, because the rules will drive higher capital levels, reduce return on

capital, and ultimately create onerous new obstacles to community banks' and mutual institutions' ability to raise capital. Community banks already have less flexibility and more challenges in obtaining access to capital than do larger money-center institutions, and mutual institutions are unable to raise capital except through retained earnings management. These rules will exacerbate those challenges. It should be noted that at a time when community banks already hold historically high levels of capital, there seems to be little rationale for such potentially damaging and burdensome regulations.

Moreover, the costs inherent in complying with these rules will impose significant new financial and manpower burdens on all banks which already are challenged by a struggling economy as well as enormous and complex new regulatory burdens created by the Dodd-Frank Act. The additional challenges that will be layered on banking institutions as a result of these proposals will therefore undoubtedly ultimately result in fewer loans at higher costs for consumers everywhere.

While we have many concerns with these proposals, we will focus the remainder of our comments on those restrictions and regulations that we believe will have the most egregious impact on our member banks.

Accumulated Other Comprehensive Income (AOCI)

The proposed rules require that unrealized gains and losses on available for sale securities (AFS) must flow through to common equity tier 1 (CET1), with sometimes daily changes in value needing to be accounted for in regulatory capital. This requirement clearly would create distortions in capital valuation, and would introduce tremendous volatility into capital calculations. These distortions, however – which could significantly change a bank's regulatory capital ratios - would not necessarily be indicative of changes in credit risk or bank equity, but more likely be reflective only of fluctuations in the interest rate. Nevertheless, the impact on a bank's lending and earnings capabilities, and on the economy at large, could be dramatic.

For example, in order to avoid market swings, banks will undoubtedly shorten up the duration of their investments, which in turn will mean lower yield and less earnings power for them. To temper these potential threats to profitability and lending ability, banks will likely make fewer investments in long maturity and local bond issuances. Moreover, the regulation may cause banks to limit, or avoid entirely, whole classes of assets, depending on those assets' sensitivity to interest rate swings. This, in turn, could create pressure – and even downgrades in credit ratings – in some asset class markets.

The impact on banks would be particularly dramatic in a rising interest rate environment, where current large gains in capital could be quickly reversed. The impact could be particularly harmful in years where the capital buffer restrictions are employed, and banks could ultimately find themselves limited by dividend and discretionary bonus restrictions.

To offset these potential risks, banks may be forced to reduce the size of their balance sheets as interest rates begin to rise – presumably as the economy heals. Ironically, in this scenario, when lending should become more robust, banks would have to reduce lending to maintain capital ratios, once again harming bank customers and hampering the economic recovery.

It should also be noted that some banks might even feel it necessary to sell their AFS securities and place all future purchases in hold to maturity vehicles, which would not only restrict banks' ability to manage their investments through different interest rate and economic cycles, but could furthermore impact the health of the markets for AFS securities, themselves.

Elimination of Trust Preferred Securities

NYBA is extremely concerned about the complete phase out (by January 1, 2022) of Trust Preferred Securities (TruPS) for all banking institutions. This requirement is contrary to the grandfathering of TruPS which was specifically granted for bank holding companies with less than $15 billion in assets in the Collins amendment to the Dodd-Frank Act, and is likely to result ultimately in the need to reduce assets as raising additional capital becomes more challenging.

The retention of TruPs by the smallest of bank entities was explicitly grandfathered by Congress, in recognition of the fact that small community banks have more limited sources of capital, and have therefore historically depended on this cost effective capital source to help grow bank balance sheets. The Collins amendment was designed to allow smaller institutions the opportunity to replace TruPS as they matured, in an orderly replacement process. It seems highly unfair to now overturn this legislative mandate, and subject the smallest of banking institutions to additional, unexpected capital planning. The proposed rule would clearly serve only to put more pressure on those banks least able to find alternative sources of capital at a time when they are already facing stringent new requirements for more and higher quality capital.

Application to Savings and Loan Holding Companies (SLHCs) and Mutual Holding Companies (MHCs)

The capital proposal requires all SLHCs and MHCs, regardless of size, to comply with Basel III. By contrast, small bank holding companies (SBHCs) - with assets of $500 million or less in consolidated assets - are exempt. This inequity, based solely on the type of charter held by the holding company's subsidiary, makes little sense. This is particularly true, as the Federal Reserve Bank's longstanding policy of exempting SBHCs from its capital rules, is based on the fact that typically the only activity of a SBHC is the holding of the stock or controlling interest in the bank, which is, itself, subject to capital rules. SLHCs and MHCs, too, typically limit their activity to the holding of the stock or controlling interest

in the banking subsidiary ; exempting one type of holding company and not the other, is therefore unfair and seemingly without a compelling policy rationale.

<u>Mortgage Servicing Assets</u>

Under the proposed rule, banks would not be able to count as part of their CET1 capital measure any mortgage servicing assets (MSAs) - net of deferred tax liabilities – that exceed 10% of their CET1. When aggregated with deferred tax assets and investments in common stock of an unconsolidated financial entity, all of that together could not exceed 15%. The amount of MSAs below the 10% threshold would receive a 100% risk weight, until 2018, when they would receive a 250% risk weight.) NYBA believes that these requirements would have a significant negative impact on banks with retail mortgage servicing operations, and could encourage banks to sell loans with servicing rights released. This eventuality would have a significant impact on all banks, including community banks, who utilize their servicing relationships to maintain broader customer relationships - once again placing additional financial burdens on banks already overwhelmed by financial challenges and regulatory requirements. It would be particularly unfair to apply this rule to existing MSAs, as banks have created and nurtured their current MSA portfolios based on current regulatory capital treatment, and with no reason to expect that their ability to include MSAs in regulatory capital would be so diminished.

<u>Risk Weighting for Residential Mortgage Loans</u>

The proposal assigns risk weights to residential mortgages based on whether the mortgage is a "traditional" category I mortgage or a "riskier" category 2 mortgage and the loan-to-value (LTV) ratio of the mortgage. We do not believe, however, that the types of loans assigned to these categories accurately reflect their actual or relative risk; nor do we believe that quantitative data currently exists to support these new risk weightings.
Yet, it is clear that the new risk weighting requirements will mandate that more capital be held, will discourage heretofore traditional mortgage products from being offered in the future, will reduce credit availability and will increase the cost of mortgage credit going forward. As the Conference of State Bank Supervisors (CSBS) wrote in its October 3, 2012 letter to the Agencies "[t]he definition for a Category I mortgage loan and the ability to achieve the more favorable risk weights is very narrow. This will likely cause banks to curtail or eliminate traditional adjustable rate products that banks have originated successfully for decades. The Category II risk weights are so punitive in nature banks will have a very difficult time extending loans secured by home equity. This is an important source of credit for consumers and small business."

The impact of these rules is further exacerbated by the dramatic increase in regulatory burden and expense inherent in complying with them. As the Standardized Approach NPR expressly recognizes, many banks would be" required to change their internal reporting process," provide "additional personnel training and expenses related to new systems (or

modification of existing systems)," and "obtain additional information...in order to determine the applicable risk weights." Moreover, the proposed new rules, as they apply to mortgages, do not grandfather the existing risk-weighting of mortgages originated before the effective date of any final regulation. The operational challenges for existing portfolios, however, would be particularly egregious, as the data required to be collected might be difficult or even impossible to obtain.

The imposition of this new and unnecessary risk weighting framework on top of the myriad new requirements mandated by Dodd-Frank and its resultant regulations, can only further delay a housing market recovery which is key to the economic strength of our national economy. We agree with the CSBS, that there is not "sufficient support for many of the specific risk-weights in the framework." We also believe that any perceived benefit of the rules are far outweighed by the demonstrable negative impact on mortgage lending that their implementation would create.

We thank you for the opportunity to comment on these important proposals, which we believe, if implemented, will harm, rather than support, the strength of our banking system and of our economy.

Sincerely,

Michael P. Smith