Via Electronic Submission

October 20, 2012,

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Re: Regulatory Capital Rules

Ladies and Gentlemen:

International Bank of Chicago ("IBC") welcomes the opportunity to provide the Office of the Comptroller of the Currency ("OCC"), the Federal Reserve Board ("FRB") and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "Agencies") with comments on the three proposed rules implementing regulatory capital reforms (the "Proposed Rules").[1] The Proposed Rules purport to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act").

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1 Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action ("Basel III Rules"); Advanced Approaches Risk-based Capital Rule ("Advanced Approaches Rules"); Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets ("Standardized Approach Rules"), the OCC, FRB and FDIC, June 12, 2012 (*avail. at* http://www.federalreserve.gov/newsevents/press/bcreg/20120612a.htm).

The IBC conceptually supports the Agencies' efforts to better align regulatory capital requirements as necessary with banking organizations' risk profiles. The recent economic crisis illustrated the weaknesses of the capital structure of large banks engaged in international credit intermediation. However, as drafted, the Proposed Rules would be harmful at best and fatal at worst for community banks and particularly, minority banks, which do not engage in the types of behaviors with which the Agencies are concerned. Indeed, like its predecessor Basel II, Basel III was designed with large, complex banking institutions in mind; community and minority banks, which have been attempting to help their communities weather the economic crisis caused by the financial crisis, did not expect the Basel III regime to apply to them and should be exempted from the Proposed Rules, or at least have the Proposed Rules materially tailored to them, as we explain below.

When the Agencies implemented Basel regimes with respect to Basel II, they correctly recognized that a one-size-fits-all approach is not appropriate for our two-tier banking system, and therefore allowed the simpler, less burdensome Basel I capital requirements to continue to apply to all but the largest U.S. banks. As discussed below, without special consideration on the part of the Agencies in this instance, faced with the new capital rules, many community and minority banks will be rendered ineffective or even fail, leaving low-income communities without viable banking options and threatening the nation's economic recovery.

In this letter, we focus principally on IBC, part of the nation's minority banks, although the analysis also applies to U.S. Department of the Treasury certified Community Development Financial Institutions ("<u>CDFIs</u>") serving low-to-moderate income inner city and rural communities, of which minority banks make up a significant constituency. We first explain why minority banks deserve special consideration, due to both their unique mission and under statutory directive. We then demonstrate why these considerations require the Agencies to provide exemptions from or alternatively tailor the Proposed Rules for minority banks. The strength of these positions, unto themselves, warrant the relief requested. However, the basis for granting the relief becomes all the more compelling when considered in light of the dictates of Section 308 of the Financial Institutions Reform, Recovery and Enforcement Act ("<u>FIRREA</u>"), as also discussed below.

I. The Agencies Must Give Minority Banks Special Consideration

In many respects, the characteristics that define minority banks put them at a competitive disadvantage to their traditional, larger bank peers, at least when comparisons are based upon corporate profitability metrics. Minority banks generally operate their branches exclusively in low- to moderate-income communities, in both inner cities and rural areas. The need for these banks in such communities has been well documented. GAO Report 07-6, *Minority Banks: Regulators Need to Better Assess Effectiveness of Support Efforts*[2] (the "<u>GAO Report</u>") outlined how crucial these minority banks are to minority communities, explaining that "[d]espite their small numbers, minority banks can play an important role in serving the financial needs of

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[2] U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-07-6, MINORITY BANKS: REGULATORS NEED TO BETTER ASSESS EFFECTIVENESS OF SUPPORT EFFORTS (2006).

historically underserved communities, such as African Americans, and growing populations of minorities, such as Hispanic-Americans and Asian-Americans."[3]

Even without the burden imposed by the Proposed Rules, given their social mission, minority banks struggle to maintain capital levels near to those of their larger bank peers, as highlighted in the GAO report.[4] Even during normal economic cycles, minority banks cannot access high-income customers, such as those located in affluent suburbs. Additionally, banks operating out of low-income communities cannot leverage like traditional banks because their loans tend to have smaller balances due to the lower income of the borrowers. These loans also tend to have higher risk profiles because the asset quality is generally concentrated within low-income communities, and this requires a higher level of underwriting and servicing services. As a result of these considerations, even in normal economic times, minority banks have lower capital levels and profitability than their larger bank counterparts. Minority banks nonetheless have accepted this economic disadvantage as an unfortunate trade-off to pursue their social mission, rather than the pure profitability maximization focus that is the hallmark of larger banks.

However, the subprime mortgage crisis and the resulting Great Recession, which was longer and more severe than anyone anticipated, has pushed the minority banking sector to the brink. For the communities these minority banks serve, the social ramifications of bank failure have been, and will continue to be, even more compelling. Simply put, these banks are often the lifeblood of their communities, which are the location of a significant segment of the urban minority population.

In the long process implementing Basel III, the global regulators have consistently altered the rules in response to the concerns that economies would be adversely affected if the final rules were too harsh. The inner-city community deserves no less consideration as the Agencies implement Basel III in the U.S. framework. Indeed, unlike the global Basel III framework, which unto itself has no force of law and only is being implemented (particularly as to minority and other non-global banks) on a prudential basis by the Agencies, there is a specific US statute protecting minority banks. Recognizing the need for strong minority banks in the communities they serve, Congress enacted Section 308 of FIRREA. Section 308 directed the FDIC and the now-defunct Office of Thrift Supervision ("OTS") to pursue the following five goals:

3 *Id.* at 1. *See also, e.g.*, Ben S. Bernanke, Board of Governors of the Federal Reserve System, at the Independent Community Bankers of America National Convention and Techworld, Nashville, Tennessee (via prerecorded video) (Mar. 14, 2012), *avail. at* http://www.federalreserve.gov/newsevents/speech/bernanke20120314a.htm (noting that community banks are a "critical component" of the financial system that "keep their local economies vibrant by taking on and managing the risks of local lending").

4 For example, although a bank is considered to have adequate profitability if it has a return on assets ("ROA") of at least one percent, and larger minority banks with $100 million of assets or more generally met this threshold, the 42 percent of minority banks with under $100 million of assets had an ROA of just 0.4 percent. Of those smaller banks, the African-American banks, which represent 61 percent of overall African-American banks, had a dismal average ROA of 0.16 percent. Their larger African-American bank counterparts did not fare much better: those with $500 million to $1 billion in assets had an average ROA that was a third lower than their peer group, and those with $100 million to $300 million in assets had an average ROA that was 75 percent less than their peers. GAO Report at 11, 12, 15.

(*1*) Preserve the present number of minority banks; (*2*) Preserve their minority character in cases involving merger or acquisition of a minority bank by using general preference guidelines; (*3*) Provide technical assistance to prevent insolvency of minority banks not now insolvent; (*4*) Promote and encourage creation of new minority banks; and (*5*) Provide for training, technical assistance, and educational programs. FIRREA signaled to the Agencies that the development of minority banks should be a priority.

The Agencies have largely complied with the relatively clear, straightforward, easy to implement FIRREA mandates regarding training and technical assistance to minority banks.[5] However, as the GAO Report and the figures on ROA demonstrates, there is more work to be done. The situation for minority banks and CDFIs has become increasingly dire since the subprime mortgage and subsequent recession. Raising capital and deposits under current conditions is difficult for any financial institution and nearly impossible for minority banks or CDFIs, whose customers generally have smaller deposits. Yet the Agencies would be requiring minority banks and CDFIs to do just that by inappropriately applying the Proposed Rules to such banks. This will cause a monumental crisis for minority banks and CDFIs and literally threatens the viability of the sector.

U.S. Basel III implementation thus crystallizes an opportunity for the Agencies to demonstrate that they give more than lip service to the dictates and policy objectives of Section 308. Without special consideration in the Proposed Rules on the part of the Agencies, regardless of how many outreach and educational programs the Agencies provide under Section 308, minority banks, which are already in perilous condition, will be rendered "zombie banks" or even fail, leaving low-income communities without viable banking options. By exempting minority banks from Basel III or significantly tailoring its provision, as described herein, the Agencies will at last provide a tangible demonstration that Section 308 of FIRREA is of more than illusory benefit to the minority banks and the communities they serve.

II. The Proposed Rules Should Not Apply to Minority Banks and CDFIs

For the foregoing reasons, the IBC strongly submits that the Proposed Rules should exempt minority banks. Basel III is an international standard that is intended to apply only to the largest, internationally-active banking organizations. Minority banks and CDFIs, which by definition transact almost exclusively locally and do not engage in international credit intermediation, did not anticipate needing to comply with the Basel III capital requirements. However, under the Proposed Rule, *all* insured banks, regardless of asset size or activities, will be subject to the Basel III minimum regulatory capital proposal.

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[5] As the GAO Report discusses, the Agencies have implemented various training and technical assistance programs. The Agencies have created web pages, directed and participated in seminars, sponsored an annual Interagency Minority Bank National Conference, and the FDIC and OCC both have published policy statements describing their efforts regarding minority banks. The GAO Report even cites agency claims of helping minorities to obtain deposit insurance and thrift charters, and, if a minority bank falls into troubled condition, "officials from the OCC, Federal Reserve, and OTS said that they provided technical assistance to such institutions." GAO Report at 26-27.

Basel III was drafted in the wake of the financial crisis to address the roots of the downturn. In particular, Basel III was designed to reduce the international "interconnectedness of systemically important, too-big-to-fail financial institutions" and to prohibit excess leverage and insufficient capital of those large, globally-active institutions.[6] As the Agencies acknowledge in the Proposed Rules, Basel III was based partly on the results of a 2010 quantitative impact study, which found that stronger capital structures at *internationally active* banks would lower the probability of banking crises.[7] It is the risky acts and capital structure of those global institutions, not minority banks or CDFIs, that caused the financial crisis.

Minority banks do not transact internationally. Rather, minority banks are focused on providing credit and banking services to their immediate communities, many of which have no other means of accessing such services. The Agencies state that the Proposed Rules will "result in capital requirements that better reflect banking organizations' risk profiles."[8] However, minority banks do not engage in the types of credit intermediation at which the Proposed Rules were aimed. Because Basel III was not designed to apply to relatively small, local banking organizations that do not engage in international activities, and because FIRREA requires the Agencies to give special consideration to minority banks, the Proposed Rules should not apply to such banks. We should note that Basel II provides a very recent, very compelling precedence for this distinction. There, as here, the Agencies appropriately recognized that Basel II's policies are more appropriately directed toward the dozen or so largest US banks with the remainder able to remain under the current system. Until the Proposed Regulations were published this is exactly the result that the minority banks (and indeed virtually all U.S. banks) anticipated with respect to Basel III.

III. In the Alternative, the Proposed Rules Should Make Appropriate Adjustments to Accommodate Minority Banks

If, despite the foregoing arguments, statutory dictates and recent analogous precedent, the Agencies do not completely exempt minority banks from the Proposed Rules, they must, at the very least, substantially amend the Rules to reflect the unique capital structure of minority banks; without such amendments, minority banks will be irreparably harmed, and many likely will fail. In particular, minority banks would be harmed by the common equity requirement within the capital calculations. Additionally, the risk-weighting standards imposed by the Proposed Rules will put further strain on minority banks given their social mission. Each of these issues are discussed in detail below.

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6 Stefan Walter, Secretary General, Basel Committee on Banking Supervision, Speech at the 5th Biennial Conference on Risk Management and Supervision, Financial Stability Institute, Bank for International Settlements (Nov. 3, 2010).

7 <u>Basel III Rules</u>, at 17.

8 <u>Basel III Rules</u>, at 12.

A. The Common Equity Requirement Would Give Minority Banks the Option of Either Failing or Losing Their Minority-Owned Character

The IBC appreciates that the Agencies have included non-cumulative perpetual preferred in the tier 1 capital base in the Proposed Rules. However, the Proposed Rules require all banking organizations, including minority banks, to maintain a new common equity to risk-weighted assets ratio of at least 4.5 percent and as high as 7 percent. However, for the reasons described below, the imposition of the new common equity ratio could force minority banks to make a choice: (1) fail, due to inability to meet this standard; or (2), as described in more detail below, raise stock in a dilutive offering and lose their minority-owned character. This Hobbesian choice is completely inconsistent with public policy, not to mention FIRREA Section 308. The Agencies must exempt minority banks from the common equity standard.

Minority banks, especially those that are minority-owned as opposed to minority-managed,[9] historically have a relatively high percentage of preferred stockholders that are large, prominent nonbank companies, such as insurance, oil, and media companies, that provide long-term, stable sources of capital. These stockholders specifically invest in nonvoting preferred stock, rather than in voting common stock, so that they can make social investments in minority banks without becoming a bank or thrift holding company. These investors know their investments strengthen the particularly endangered minority-owned minority banks, which are a vital contributor to wealth creation within low-income communities. These investors thus are seeking returns not principally based on short-term profit motives. They provide sufficient capital that is at least as stable as the common equity required by the Proposed Rules, without disrupting the character or mission of the minority banks.

Majority banks can publicly offer common stock to raise necessary capital, but this method is not practicable or available to minority banks. An essential characteristic of minority banks is that their active shareholder (as opposed to the institutional base described above) base is part of the minority community. Any public offering of stock, with its inevitable dilution of ownership, will very likely result in a loss by a minority bank of its controlling minority stockholders. Institutional investments in noncumulative perpetual preferred stock are thus the ideal solution to allow minority banks to raise needed capital while maintaining their status as a minority bank. If the Proposed Rule is applied to minority banks, the Agencies must amend it to eliminate the separate common stock requirement as to minority banks, and thus allow this symbiotic, critical relationship between minority banks and nonvoting preferred institutional investors to continue.

9 In the FDIC's Policy Statement Regarding Minority Depository Institutions, 67 Fed. Reg. 18,620 (Apr. 16, 2002), the FDIC expanded the definition of minority depository institutions set out in FIRREA to include any bank that had the majority of its board of directors be minority members and if the community in which the bank serves is predominantly minority. Though this expands the number of institutions given special consideration due to their minority bank status and recognizes their important role of managing assets in underbanked communities, minority-owned minority banks are true sources of wealth creation within these communities.

B. Risk Weighting Must Be Tailored to Minority Banks and CDFIs

In response to the unprecedented levels of mortgage defaults during the financial crisis, the Proposed Rules set out a more risk-sensitive treatment for risk-weighted real estate assets. Currently, real estate loans are given risk weights of between 50 and 100 percent; the Proposed Rules introduce risk weights up to 200 percent. In particular, both Category 1 and 2 loans will be assigned varying risk-weights depending on the loan-to-value ratio and high-volatility commercial real estate loans will be assigned a risk weight of 150 percent, up from 100 percent currently. Additionally, the unsecured or non-guaranteed portions of certain loans that are 90 days or more past due are assigned a risk weight of 150 percent.

The newly introduced risk weighting will further exacerbate the difficulties to minority banks posed by the Proposed Rules, and will hamper the development of housing and infrastructure in urban, inner-city communities that desperately need it. The majority of the assets of minority banks and CDFIs are in commercial and residential real estate loans made to the communities in which they are based, which depend on these loans to develop housing and neighborhood infrastructure, such as churches and new businesses. The residential real estate loans made by minority banks within moderate-to-low income neighborhoods, vital to the improvement of such areas, are generally not classified as Category 1 loans, and generally have very high loan-to-value ratio because the mortgagors are usually moderate-to-low income individuals. Minority banks do not have a high default rate on these loans because, as stated above, they know their communities and devote substantial time and effort to underwriting and servicing those credits that are critical to their communities. The Proposed Rules, as written, would improperly ignore the actual performance of these loans. Instead, minority banks should be permitted to continue to calculate loan charges under the current Basel I standard.

Similarly, the new risk weighting on past due loans will create undue burdens for minority banks. Under the Proposed Rules, minority banks will be penalized for past-due loans already made, even if the underwriting of such loans is perfect and fully consistent with their mission. Moreover, as indicated above, due to their high-touch servicing standards, these loans are much less likely to default than majority bank past due loans. Nonetheless, the sharp increases in the risk weights for commercial and residential mortgage assets will make it even more likely that minority banks will be undercapitalized under the Proposed Rules. These areas desperately need credit. If these banks are discouraged from making the loans they currently provide, economic recovery in low-to-moderate income areas will be stymied.

As the Agencies suggest in the Proposed Rules,[10] minority banks should be allowed to choose to continue using the same risk weights under the current general risk-based capital rules, including for commercial and residential mortgage exposures, to calculate the denominator of the risk-based capital ratio. As we discussed above, these small banks did not anticipate needing to comply with the Proposed Rules. Such an exemption would allow minority banks and CDFIs to maintain their current level of lending to these woefully underserved communities.

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[10] Question 2, page 17 of Standardized Approach

In the alternative, if the Agencies do require small banks to use only the new risk weights, then the risk weights for non-Category 1 residential and commercial real estate loans and past due loans must be reduced for minority banks and CDFIs. Because of their unique social mission, the asset portfolios of such banks are composed mostly of those particular loans. Thus, the increased risk-weights will have an acutely detrimental effect on such banks relative to their larger bank peers. Therefore, the Agencies must appropriately decrease the risk-weights applied to real estate loans to encourage the business of minority banks and CDFIs.

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We thank the Agencies for the opportunity to comment on the Proposed Rules. If you have any questions, please do not hesitate to contact me at (708) 410-2899.

Sincerely,

Donald J. Stahl

Executive Vice President and CFO