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Via E-Mail: regs.comments@federalreserve.gov
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Federal Deposit Insurance Corporation
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Re: (i) Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, Docket ID OCC-2012-0008; Docket No. R-[XX]; RIN 3064-AD95 (the "**Basel III NPR**"), and (ii) Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, Docket ID OCC-2012-0009; Docket No. [XX] [XX]; RIN3064-AD96 (the "**Standardized Approach NPR**") (the Basel III NPR and the Standardized Approach NPR being collectively, the "**NPRs**")

Response of The Risk Management Association's Community Bank Council

I. Introduction and Overview

The Risk Management Association ("**RMA**") appreciates this opportunity to respond to the Basel III NPR and the Standardized Approach NPR, each dated June 7, 2012, which together outline broad principles to be used by banking organizations in capital planning.

RMA is a member-driven professional association whose sole purpose is to advance the use of sound risk principles in the financial services industry. RMA helps its members use sound risk principles to improve institutional performance and financial stability, and enhance the risk competency of individuals through information, education, peer-sharing and networking.

One of the most important components of RMA's mission is to provide independent analysis on matters pertaining to risk and capital regulation. In this regard, the comments contained herein are informed by subject matter experts from member institutions of RMA’s Community Bank Council.

RMA has stressed that capital requirements for any given institution should always, as accurately as possible, reflect the risk associated with bank exposures and should be commensurate with the size, scale and complexity of the institution.

By applying these two NPRs not just to the largest and most complex banks, but to all banking organizations that are currently subject to minimum capital requirements, it is clear that the purpose of the NPRs is to express a very broad set of expectations and standards that apply to banks that vary greatly in terms of size, scale, complexity and risk profiles. RMA notes that bank capital levels are just one facet of effective bank risk management, and cautions that capital levels alone are not an absolute measure of bank soundness. The other facet is the institution's risk level, which is guided by its enunciated risk appetite and demonstrated by its performance and adherence to its risk appetite policy statement. Accordingly, bank soundness flows from a combination of capital levels and risk levels.

II. Comments On Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, And Prompt Corrective Action

As a threshold matter, the members of the Community Bank Council (the “**Council**”) fail to comprehend the rationale for applying the Basel standards to community banks, which for recent statutory and regulatory purposes, have come to be defined as those banks having assets less than $10 billion. The Basel capital regime was intended only for large, internationally active banks. We note that both NPRs exceed the intended scope of both Basel II and Basel III and are not required under the Dodd-Frank Act or any other U.S. law. For this reason alone, the Council respectfully suggests that the Basel III rulemaking exclude from coverage banks under $10 billion in total assets.

The harmful effect of the Basel III capital requirements as applied to community banks was duly noted by Congressman Don Manzullo (R-IL) who stated on June 8, 2012 that:

The community banks had nothing to do with the financial crisis and they should not have to deal with this stricter oversight. Forcing these smaller banks to hold all this extra money in reserve will mean they will have less money to lend to the entrepreneurs looking to expand and put Americans back to work. This will devastate our economic recovery and our small employers' ability to create jobs.[1]

We note that in the past several years the total number of financial institutions in the United States has declined, while the concentration of assets among the systemically important financial institutions ("**SIFIs**") – for whom Basel is intended – has increased substantially. Underscoring this is the fact that, as of March 31, 2012, the top five institutions held a combined $8.5 trillion in assets, which represents approximately 45% of total industry assets.[2] In contrast, the approximately 6,800 community banks with less than $1 billion in assets represent slightly more than 10% of industry assets, ***and*** provide almost 40% of all small business loans.[3]

The present economic environment has severely curtailed community banks' attempts to raise capital. According to the Conference of State Bank Supervisors, the typical capital offering for community banks ranges from $20 to $30 million, which is generally too small for many institutional investors regardless of deal structure or motivation.[4] Raising or replacing capital today, whether in the public or private markets, is more than challenging for many community banks. Potential investors are scarce, with a growing number more interested in acquiring branches and assets of failed banks, rather than purchasing stock or assets of open banks. Simply put, extending the Basel III requirements to community banks puts these banks in an untenable position for which there is no practical solution.

Because community banks do not have the same access to capital as their larger counterparts and because community banks will have similar regulatory and compliance requirements, the Basel III NPR will have a significantly negative effect on community banks' ability to compete with larger institutions for both capital and banking business. This will have the unintended consequence of driving M&A activity in the community bank market as it may also result in certain geographic areas traditionally served by community banks being unserved or underserved by larger banking organizations,

[1] Statement of U.S. Representative Don Manzullo, June 8, 2012, http://manzullo.house.gov/

[2] http://www.ffiec.gov/nicpubweb/nicweb/Top50Form.aspx

[3] Remarks by FDIC Acting Chairman Martin J. Gruenberg to the American Banker Regulatory Symposium, Washington, DC, September 19, 2011.

[4] Conference of State Bank Supervisors, Community Banks and Capital: Assessing a community bank's need and access to capital in the face of market and regulatory challenges, December 2011.

particularly in sub-suburban and rural areas which are traditionally served primarily by community banks.

Moreover, the Council is concerned that, should these NPRs take effect, the regulatory and compliance burden facing community banks will be unduly heavy and would not be commensurate with the size, scale and complexity of the community bank business model. For the foregoing reasons, the Council respectfully suggests that these rulemakings be restricted to banks with greater than $10 billion in assets. This is consistent with pre-NPR-release industry expectations and would allow community banks the opportunity to manage their assets proactively, taking into account their risk appetites.

In the event the Agencies decline to restrict the Basel III final rulemaking to institutions having more than $10 billion in assets, the Council offers the following additional comments. The Basel III NPR would generally apply Basel III to all U.S. banks. Within the Basel III NPR, the Agencies have also addressed other aspects of U.S. bank capital regulation that interface with Basel III, most importantly the thresholds for remedial action under the Agencies' prompt corrective action ("PCA") regulations applicable to depository institutions (but not holding companies) and the phase-out periods for trust preferred securities and cumulative preferred stock as Tier 1 capital components for bank holding companies that are required by the Collins Amendment. Basel III requires the phase-out from Tier 1 Capital of trust preferred securities and cumulative preferred stock over a 10-year time period beginning on January 1, 2013; the Collins Amendment requires a phase-out of trust preferred securities over a three-year period beginning on the same date, but only for bank holding companies that had $15 billion or more in total consolidated assets as of December 31, 2009. Consistent with the Collins Amendment, the Council respectfully suggests that community banks continue to be exempted from the phase-out of trust preferred securities and from the phase-out of cumulative preferred stock due to the above-described obstacles to capital-raising faced most notably by community banks.

Basel III also provides for a capital conservation buffer of 2.5%, composed of Common Equity Tier 1 capital and added to each of the minimum requirements (that is, the minimum Common Equity Tier 1, Tier 1 and Total Capital requirements). The Basel III NPR follows Basel III and would apply the capital conservation buffer to all banks. Banks that invade their capital buffers are restricted in their ability to pay dividends and make other capital distributions, and to pay discretionary executive compensation. As a practical matter, banks will likely feel compelled to maintain capital at levels that include a meaningful cushion above the minimum requirements plus the 2.5% buffer in order to avoid the limitation on capital distributions and executive compensation.

The Basel III NPR takes a "one size fits all" approach to the application of the capital conservation buffer. As previously stated, community banks do not have the same access to capital as their larger counterparts or the same risks in terms of their business model. Moreover, adding the capital conservation buffer requirement may have the unintended consequence of (a) making it even more difficult in a recessionary environment to raise sufficient capital, and (b) causing talented people at community banks to seek other opportunities if they feel their total compensation packages are at risk. This latter factor could serve to exacerbate any problems being encountered in a community bank and, thereby, make the buffer requirement counter-productive. The Council respectfully requests that community banks be exempted from the capital conservation buffer, or alternatively, that the buffer be phased in over time, while preserving the attendant restrictions on executive compensation and capital distributions.

S corporations are also subject to a potentially serious unintended consequence from the capital conservation buffer in addition to the issues described above. Generally, S corporations are permitted to make tax distributions to their shareholders that correspond to the shareholders' tax liabilities. As presently written, the capital conservation buffer would preclude an otherwise well capitalized S corporation from making tax distributions to its shareholders. Accordingly, RMA respectfully suggests that S corporations be exempted from the requirements of the capital conservation buffer, and barring that, RMA respectfully requests that the capital conservation buffer be revised to first permit S corporations to make tax distributions.

The Council is also concerned about the potential adverse impact arising from the proposal to have unrealized gains and losses on all available-for-sale (AFS) securities flow through to Common Equity Tier 1 capital. This change would cause to be included those unrealized gains and losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk. The agencies have noted that this proposed change could add considerable volatility to required capital ratios.

In the past, the banking agencies considered adopting such an approach for regulatory capital purposes, but previously declined to do so for reasons the Council believes continue to be relevant. Community banks would be subject to potentially devastating swings in capital due to changes in market interest rates impacting the values of AFS debt securities. The Council believes that this potential volatility will force community banks to maintain capital levels in excess of the proposed capital buffer levels in order to ensure that negative interest rate swings do not cause capital ratios to invade the buffers. This prospect merely adds to the capital-raising pressure on smaller banks as previously noted.

In order to counter such regulatory capital treatment, the Council speculates that community bankers would move securities to the "held to maturity" portfolio, adversely impacting liquidity risk management capability. The Council also believes it likely that bankers would change investment strategies to avoid the potential adverse consequences of volatility in capital levels by purchasing lower-yielding securities of shorter duration (and perhaps focusing on shorter-term portfolio impacts rather than longer-term investment strategies). Regulators have previously acknowledged that such actions by bank management could have their own adverse consequences on bank capital levels.

The Council remains concerned about the application of market value accounting to community bank balance sheets, noting that recognizing unrealized gains and losses may present a misleading picture of a bank's financial condition. Although these unrealized gains and losses may reflect market value, banks may never realize the dollar values of such gains and losses. The Council strongly recommends that unrealized gains and losses on U.S. Government, agency, government-sponsored entities and other debt securities whose values primarily change as a result of changes in benchmark rates be excluded from the final Basel III regulatory capital rule.

III. Comments On Regulatory Capital Rules: Standardized Approach For Risk-Weighted Assets; Market Discipline And Disclosure Requirements

From the standpoint of community banks, the risk weightings assigned to mortgages and commercial real estate contained in the Standardized Approach NPR will likely have the effect of requiring community banks to hold more capital given the concentrations of their portfolios. We would note that community banks are significantly important to the communities that they serve, providing residential, commercial, retail and agricultural loans for individuals and businesses that serve the local community and which provide a significant source of employment for such communities. The Council believes that the increased risk weightings and concordant capital requirements will make it difficult for community banks to sustain the same lending levels on a go forward basis.

The Standardized Approach NPR would maintain the current risk-based capital treatment for residential mortgages that are guaranteed by the U.S. government or its agencies. Accordingly, residential mortgage exposures that are unconditionally guaranteed by the U.S. government or a U.S. agency would receive a zero percent risk weight, and residential mortgages that are conditionally guaranteed by the U.S. government or a U.S. agency would receive a 20% risk weight. All other mortgages, including home equity loans, would be subject to higher risk weightings which could be as high as 200%

depending upon their loan-to-value ratios. As a result, banks with high concentrations of residential mortgages without federal government guarantees would generally see a reduction in their capital ratios, which has the potential to be quite stringent.

Moreover, the Standardized Approach NPR would not recognize PMI for purposes of calculating loan-to-value ("LTV") ratios. The Council submits that the Standardized Approach NPR should be revised to recognize the use of PMI in the LTV calculation given that PMI mitigates the underlying credit risk by reducing the risk of economic loss from the underlying mortgage; i.e., PMI reduces the severity of loss on a residential mortgage loan by the face amount of the PMI coverage. Accordingly, the insured institution has clearly reduced its risk compared to a substantially similar loan which is not subject to PMI. The issue, thus, becomes, whether the insurer itself has adequate funds to pay any claim. The Council respectfully submits that while the interests of PMI insurers and lenders are clearly aligned, and that while PMI insurers will themselves establish sound underwriting guidelines for the issuance of PMI, it would be appropriate for the Agencies work with the industry and the PMI industry to establish prudential guidelines to which PMI insurers would adhere. Therefore, the Council suggests the Standardized Approach NPR be revised to grant an appropriate reduction in mortgage risk weights at the individual loan level based on the amount of PMI coverage from an approved insurer in respect of such loan. This would be consistent with the Agencies' support of the use of risk mitigating techniques.

The Council has two primary concerns with respect to the risk-weighting for residential mortgages: First, that the proposed treatment of residential mortgages may have the unintended consequence of driving community banks out of the residential mortgage market and, second, that the risk-weighting treatment accorded residential real estate may threaten the existence of the thrift model, which is predicated upon making residential real estate loans.

Driving insured institutions out of the residential mortgage market, or causing an increase in the cost of residential and commercial real estate mortgage credit, could have a deleterious effect on an economy which is still tentatively recovering from the recession. This will also negatively impact job creation and retention, further lengthening the recovery period for the economy. Accordingly, the Council respectfully suggests that the final rule implemented should be carefully considered to ensure that the resulting treatment of residential mortgages, as applied to community banks, is not unduly burdensome.

The Standardized Approach NPR may also result in community banks limiting their real estate exposure and increasing their C&I exposure, which typically include lines of credit. Under the Standardized Approach NPR, the credit conversion factor ("CCF") would increase from 0% to 20% for commitments with an original maturity of one year or less that are not unconditionally cancelable by a bank. The CCF would be 50% for commitments with a maturity of more than one year that are not unconditionally cancelable; and the CCF would increase to 100% for guarantees, repurchase agreements, off-balance sheet securities lending transactions, standby letters of credit and forward agreements. The Council is concerned that the increase in the CCF from zero (0) to a minimum of 20% will unfairly constrain the community bank business model by requiring community banks to hold higher capital in respect of unused portions of lines of credits.

IV. Conclusion

The Community Bank Council has very real concerns over the breadth and scope of the NPRs, particularly: the increased regulatory and compliance burdens; the impact of risk-weightings of residential mortgages on that market segment and on bank capital; and, the difficulty that community banks face in attracting capital in the current recessionary environment.

As the FDIC has noted:

> … *what happens to these (community) banks is not insignificant. Another reason is that from an economic viewpoint, these institutions remain very important in specific business and economic sectors, notably small-business and agricultural lending. Small businesses play a critical role in the U.S. economy as a whole and in economic growth in particular, so their ability to find credit—and where they find it—is of consequence.*[5]

Because of their standing in, and understanding of, their local communities, community banks -- as the term implies -- have been historically owned by local business persons and community leaders. These investors have generally taken a long term view about their banks and their role in the local community and have not been constrained by the same ROI pressures as institutional investors of larger institutions. The Council is concerned that the application of large bank capital rules to community banks will be anticompetitive in respect of community banks and may have the unintended consequence of harming local communities by driving M&A activity and incentivizing community banks to raise capital from institutional investors who traditionally do not invest in community banks, which is not necessarily in the best interest of the local communities historically served by community banks.

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[5] FDIC Banking Review, The Future of Banking in America, Community Banks: Their Recent Past, Current Performance, and Future Prospects.

It is important to stress that community banks operate under a vastly different business model for which the Basel standards and expectations are not appropriate because such standards and expectations are not scalable to the community bank business model. We would respectfully request that the Agencies carefully consider the negative impacts of the NPRs on the community banking model and the benefits that the current community banking model provide to the U.S. economy as it attempts to rebound.

In summary, the Council believes that the Basel III NPR and Standardized Approach NPR will unreasonably burden community banks by increasing capital ratios, narrowing regulatory capital and increasing risk weights, all of which will restrict profitability, reduce lending capacity, and classify certain loans as high risk, that are otherwise safe/sound loans which meet the needs of community bank customers.

Should there be any questions concerning the comments reflected above, kindly contact Edward J. DeMarco, Jr., General Counsel and Director of Regulatory Relations at (215) 446-4052 or edemarco@rmahq.org.

Submitted on behalf of the Community Bank Council of The Risk Management Association.

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