April 9, 2019

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
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Suite 3E-218
Washington, DC 20219

Ms. Ann E. Misback
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

Re: Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations

Dear Ladies and Gentlemen:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the proposed rule *Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations*. This proposed rule is being issued pursuant to the Economic Growth, Regulatory Relief, and Consumer Protection Act (the Act), which directs the federal banking agencies to develop a community bank leverage ratio (CBLR). ICBA appreciates the quick response that the agencies have directed toward completing this call to action, especially since other Basel III amendments are pending and awaiting final rulemaking. However, ICBA believes that the agencies will need to make targeted improvements to ensure that the CBLR

[1] The Independent Community Bankers of America® creates and promotes an environment where community banks flourish. With more than 52,000 locations nationwide, community banks constitute 99 percent of all banks, employ more than 760,000 Americans and are the only physical banking presence in one in five U.S. counties. Holding more than $4.9 trillion in assets, $3.9 trillion in deposits, and $3.4 trillion in loans to consumers, small businesses and the agricultural community, community banks channel local deposits into the Main Streets and neighborhoods they serve, spurring job creation, fostering innovation and fueling their customers' dreams in communities throughout America. For more information, visit ICBA's website at www.icba.org.

meets the intent of the Act. The federal banking agencies should finalize the proposed rule with an 8 percent CBLR instead of the proposed 9 percent. The agencies should pay close attention to the impact of the current expected credit loss (CECL) accounting standard on community bank capital levels, especially with regard to those banks that choose to adopt the CBLR. The proposed limitation on high-quality community bank assets like mortgage servicing assets (MSAs) for a "qualifying community banking organization" should be raised from 25 percent of CBLR tangible equity to 50 percent of CBLR tangible equity. Additionally, community banks with MSAs that exceed 50 percent of CBLR tangible equity should not automatically be disqualified from utilizing the CBLR. The agencies should further simplify the CBLR by eliminating the separate prompt corrective action (PCA) requirement. Finally, regulators should use this rulemaking to make additional simplifications to Basel III, especially considering the impact that CECL will have on community bank capital once the final accounting standard is adopted.

**The Proposal**

The Act directs the federal banking agencies to develop a CBLR of not less than 8 percent and not more than 10 percent for depository institutions or depository institution holding companies with total consolidated assets of less than $10 billion. When a depository institution exceeds the CBLR to be developed by the agencies, that institution is considered to be in compliance with the leverage and risk-based capital requirements under the current capital rule, the appropriate capital ratio requirements needed to be considered well capitalized under the PCA framework, and any other capital or leverage requirements. The Act requires that the agencies establish procedures for treatment of community banks that fall below the agencies' CBLR level. The Act defines the CBLR as the ratio of CBLR tangible equity to average total consolidated assets. The federal banking agencies are permitted to exclude community banks from utilizing the CBLR based on risk profile.

In response to the Act, the agencies have proposed a CBLR for depository institutions and depository institution holding companies with less than $10 billion in total consolidated assets and limited off-balance sheet exposures, trading assets and liabilities, MSAs, and temporary difference deferred tax assets (DTAs). Qualifying community banking organizations would be required to have total off-balance sheet exposures that do not exceed 25 percent of total consolidated assets, trading assets and trading liabilities that do not exceed 5 percent of total consolidated assets, MSAs that do not exceed 25 percent of CBLR tangible equity, and temporary difference DTAs that do not exceed 25 percent of CBLR tangible equity. The CBLR would be calculated as the ratio of tangible equity capital divided by average total consolidated assets. Tangible equity is defined as total bank equity capital after deducting minority interests, accumulated other comprehensive income, DTAs arising from net operating loss and tax credit carryforwards, goodwill, and other intangible assets. As proposed, a qualifying community banking organization would be permitted to use the CBLR on a quarterly basis when the calculated ratio is greater than 9 percent and could make the election to opt in or opt out at any


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time. However, the agencies anticipate that elections in and out of the CBLR would be rare and would be driven by significant changes in the entity's business activities.

When a community bank fails to meet the proposed qualifying criteria for the CBLR, it enters a grace period of two consecutive calendar quarters where it must demonstrate compliance with the qualifying criteria or cease using the CBLR. If, as a result of a business combination, a community bank fails to meet the requirements of the CBLR it would no longer be considered a qualifying community banking organization and would not be allowed to utilize the grace period. In addition, all qualifying community banking organizations that elect to use the CBLR are subject to a separate PCA framework. Banks that exceed the CBLR level of 9 percent are considered well capitalized. Banks that fall below 9 percent but maintain a CBLR of 7.5 percent or greater are considered adequately capitalized. Banks that fall below 7.5 percent are considered undercapitalized. When banks fall below 6 percent they are considered significantly undercapitalized.

**ICBA's Comments**

ICBA would like to thank the agencies for proposing the CBLR so quickly after the Act was passed by Congress. The agencies appear to have thoroughly considered many of the concerns that would be expected when trying to integrate such a proposal into the complex Basel III framework. However, ICBA has many concerns about the CBLR as proposed, particularly whether the product produced by the agencies is consistent with the true purpose of community bank regulatory relief.

**The proposed CBLR is too high.** ICBA disagrees with the conclusion of the banking agencies that community banks should be permitted to use the CBLR only when the ratio is above 9 percent. Instead, we believe the ratio should be 8 percent. Establishing the ratio at 8 percent, as allowed by the statute, would calibrate the CBLR closer to current risk-based capital requirements for well-capitalized banks including the common equity tier 1 ratio of 6.5 percent and the tier 1 risk-based capital ratio of 8 percent. Furthermore, an 8 percent CBLR would put the ratio closer to the current 5 percent leverage requirement for well-capitalized banks and would allow approximately 600 more community banks to be eligible to use the new framework. ICBA also notes that the statutory net worth requirement for federally-insured credit unions requires a net worth ratio of only 7 percent. Why would the federal banking agencies take the view that community banks demonstrate enough incremental safety and soundness risk to warrant the need for a leverage ratio that exceeds that of credit unions by 200 basis points? ICBA believes that the agencies have failed to demonstrate that 9 percent is the correct measurement.

Members of the United States Senate have recently questioned the validity of the 9 percent ratio as well. In a letter dated April 5 of this year, Senators Moran and Crapo encouraged the federal banking agencies to use their discretion to set the CBLR at 8 percent.



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Once the CBLR is established, community bankers expect that the federal banking agencies will institute an unstated capital conservation buffer in addition to any CBLR that is imposed on community banks, making any stated ratio largely irrelevant for practical purposes. Depending on the size and scope of the buffer instituted by the agencies, the de facto CBLR will be higher than the stated ratio in the final rule.

For instance, if the CBLR is established at 9 percent, any bank with a CBLR of less than 10 percent will likely not opt-in to use the CBLR standard since the buffer is likely to be as high as 100 basis points. If the agencies expect a capital conservation buffer of up to 100 basis points on top of the CBLR, they should set the CBLR at 8 percent rather than at 9 percent. At a CBLR of 9 percent and a 100-basis point buffer, we estimate that fewer than one-half of community banks with less than $10 billion in assets would opt-in to use the CBLR standard. If the banking agencies expect to supervise bank capital requirements by using a capital buffer, they should set the CBLR at 8 percent to encourage community banks with at least 9 percent of capital to adopt the new standard.

**CBLR does not consider the impact of the amended credit loss standard.** As the agencies are well aware, the Financial Accounting Standards Board's CECL standard will require community banks to increase their allowances for credit losses for long-term receivables including almost all loans and certain investment securities. Upon adoption of CECL, community banks will reallocate levels of regulatory capital away from retained earnings, which will drop current capital balances. This reallocation can easily be viewed as an additional "CECL buffer" that requires community banks to hold more loss-absorbing regulatory capital outside of capital accounts. It does not appear from the proposed rule that the agencies have considered the impact of such a capital reallocation on community banks and how the change in credit loss accounting will impact community bank regulatory capital. Because the adoption of CECL will buffer the existing layer of loss-absorbing regulatory capital, a requirement to maintain a CBLR above 9 percent becomes excessive. ICBA urges the agencies to consider the impact of CECL when determining the appropriate CBLR level in the final rule and to adjust the CBLR down accordingly.

In addition to the need to adjust the CBLR for CECL, ICBA believes that the agencies should amend the numerator of the CBLR calculation to allow for the same optional transition period that is being granted banks under Basel III. Community banks should have the option to phase in the impact of the day-one CECL adjustment recorded in retained earnings when they elect to use the CBLR to calculate regulatory capital. ICBA would like to reaffirm its request that the agencies consider extending the transition period from the current three-year term to a five-year term in order to incorporate the risk that economic conditions are not favorable at the date that a community bank adopts CECL, which could be as late as January 1, 2022.



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**Certain exposure thresholds are too low to be a "qualifying community banking organization."** The proposed rule limits the ability of a community bank to maintain exposures to high quality assets like MSAs and still be a "qualifying community banking organization" that can opt-in to the new CBLR standard. High quality mortgage assets like MSAs are key earnings drivers for community banks that feel very strongly about keeping mortgage servicing in their communities and away from less customer-centric institutions and less-regulated nonbank servicers. Yet the federal banking agencies in this proposed rule continue to try to drive away local servicing opportunities by severely limiting the amount of MSAs that can be carried on the balance sheet. While higher than the severe limits imposed on community banks when they adopted Basel III, the proposed MSA cap of 25 percent of tangible equity is not nearly high enough to allow community banks to service loans in their communities.

To the community banks that service mortgages in their communities, the ability to perform such a function is critical to their success. But it is quite obvious that mortgage servicing has become a commoditized business requiring community banks to hold a large number of MSAs in order to properly perform the functions necessary to properly service community bank loans and still remain profitable. Community banks that have invested in the proper infrastructure to provide a high-quality service to their customers should not face penalties for building such a niche business. **To properly provide the flexibility needed by community banks to perform these functions, ICBA requests that the MSA threshold limit for a "qualifying community banking organization" be raised from the proposed 25 percent to 50 percent of CBLR tangible equity.**

**Exceeding imposed asset limits should not result in automatic disqualification.** In the proposed rule, a community bank can only elect the CBLR if it meets certain criteria. In the case of MSAs, once they exceed 25 percent of an institution's CBLR tangible equity, the institution enters a probationary period whereby it must curtail MSA balances or fail to be eligible to utilize the CBLR. In addition to raising the limit to 50 percent, the agencies should not automatically exclude an institution when it exceeds any MSA limit. Rather, the agencies should develop a phase out or deduction methodology where the community bank deducts MSAs when it exceeds the established limit. This treatment is consistent with how MSAs are treated today under Basel III. ICBA does not see any valid reason why the treatment under the CBLR should be any different. Prudential bank regulators have yet to provide any regulatory relief for mortgage servicers, and their options for carrying MSAs on their balance sheets – Basel III or the proposed CBLR – are both less than advantageous. ICBA believes strongly that now is the time to give community banks that choose to service mortgage loans in their communities real relief under this proposal.

**Prompt corrective action under CBLR should be removed.** The agencies have made the process for community banks to utilize the CBLR standard far too complex. Including a separate PCA framework is unnecessary. The PCA framework should be removed and replaced with a simple quarterly election by the institution. If an institution meets the requirements to follow the



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CBLR it should be allowed to do so at will. **If the institution chooses to no longer apply the CBLR or it fails to meet the minimum CBLR ratio, the PCA framework proposed here should not apply. The institution should be allowed to simply stop utilizing the CBLR and calculate regulatory capital under the existing Basel III framework.** By making the CBLR qualifications broad and the entrance and exit process simple and transparent, regulators would better meet the intent of Congress to provide real regulatory relief for community banks as was intended by the legislation. Members of the United States Senate agree with this recommendation. In the letter mentioned above, Senators Moran and Crapo call on the federal banking agencies to ensure that any PCA framework instituted will not unintentionally deter community banks from utilizing the CBLR framework.

If the agencies are unwilling to remove the PCA framework, the consequences of the proposed framework must be reevaluated. Under the proposal, the banking agencies would establish CBLR levels to serve as proxies for the existing risk-based and leverage capital ratios that currently define these PCA capital categories. The proposed CBLR levels for adequately capitalized, undercapitalized and significantly undercapitalized PCA capital categories would be as follow:

- Adequately capitalized—CBLR of 7.5 percent or greater;
- Undercapitalized—CBLR of less than 7.5 percent; and
- Significantly undercapitalized—CBLR of less than 6 percent.

The agencies are not proposing a proxy CBLR level for the critically undercapitalized category, which would continue to be calculated as the ratio of tangible equity to total assets (as defined under the PCA framework) of 2 percent or below. The agencies intend to use the proxies to apply regulatory, supervisory, and enforcement authorities under PCA and other statutes to CBLR banking organizations.

For example, if a CBLR banking organization becomes less than well capitalized, it would become subject to applicable regulatory restrictions. For a CBLR banking organization that is a depository institution, these restrictions would include the brokered deposit and interest rate restrictions. For a CBLR banking organization that is a depository institution holding company, these restrictions would include limitations on financial activities under the Bank Holding Company Act and Regulation Y.

The agencies indicate that there are two principal reasons why they are incorporating the PCA framework into the CBLR framework. First, Section 201 of the Act directs the agencies to establish procedures for the treatment of qualifying community banking organizations that fall below the CBLR level established by the agencies. Second, the agencies are concerned that a CBLR banking organization may suddenly experience a decline in its CBLR below the percentage set by the agencies (i.e., the proposed 9 percent level) and may find it burdensome to comply with the more complex risk-based capital reporting requirements at the same time that the organization is experiencing a decline in its CBLR.


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ICBA disagrees with the agencies' interpretation of Section 201 of the Act. **Section 201's direction to establish procedures for the treatment of CBLR organizations that fall below the CBLR level does not mean that the agencies must incorporate the PCA requirements into the CBLR framework.** It merely requires them to state through regulation what the consequences would be if a CBLR banking organization were to drop below the CBLR level.

Furthermore, establishing "proxies" under the CBLR framework for adequately capitalized, undercapitalized and significantly undercapitalized PCA thresholds could serve as an unwarranted penalty for banks that elect the CBLR**. Instead, a CBLR bank that falls below the CBLR should be given the opportunity to demonstrate that it is well capitalized under the current PCA Framework before being downgraded to adequately capitalized.** To do otherwise traps the CBLR bank into the CBLR framework and could result in the CBLR becoming the new, de facto minimum capital requirement for CBLR banks.

ICBA believes that any regulatory or operational difficulties that a CBLR bank might have transitioning into compliance with the current regulatory capital rules are far outweighed by the funding and liquidity difficulties that would be created by deeming a CBLR bank that falls below the CBLR less than well-capitalized. The ultimate solution for this problem is for the regulators to simplify Basel III for community banks which ICBA has been advocating for years. **However, until Basel III is completely simplified, we believe that the CBLR framework should be designed so that if a community bank falls below the CBLR, the bank would only be classified as less than well-capitalized for PCA purposes if it fails to maintain the capital ratios required to be maintained to be well-capitalized under the current PCA framework.**

**ICBA Supports a Limited Grace Period for CBLR Banks.** Even though ICBA supports a CBLR framework so that if a community bank falls below the CBLR, the bank would use the current PCA Framework before being downgraded to adequately capitalized, we still support the proposed two quarter grace period for CBLR banks that fail to meet the qualifying criteria, i.e. the $10 billion size limitation, the 25 percent MSA limitation, the 5 percent trading asset limit, etc. For instance, if a banking organization grew to $10 billion or larger in total consolidated assets, the bank should have a two-quarter grace period to shrink to below $10 billion before being disqualified as a "qualifying community banking organization." We agree with the agencies that a limited grace period is appropriate to mitigate potential volatility in capital and will capture more permanent changes in risk profile.

**Definition of tangible equity should be broad.** ICBA believes the proposed definition of "tangible equity" is an improvement over tier 1 capital and other risk-based capital standards. Under Basel III, the types of capital instruments that qualify as common equity tier 1 capital and additional tier 1 capital are quite limited. With the CBLR the agencies have the opportunity to allow community banks to include equity instruments that have cumulative characteristics with stated final maturity dates. **These instruments should not be disqualified from the CBLR**

**simply because they do not possess perpetual lives.** The federal banking agencies should recognize their loss-absorbing capabilities and include them as eligible capital instruments included in the numerator of the CBLR calculation both at the bank level and, where applicable, the consolidated level.

Included in the tangible equity definition should be any grandfathered trust preferred securities (TruPS) issued at the holding company level.[2] The importance of these securities has already been recognized when the federal banking agencies allowed them to be included in regulatory capital with the finalization of Basel III. Community banks that issue TruPS are not systemically risky institutions that deserve to be penalized just because they were issuing financial instruments deemed not as "pure" as common equity when loss-absorbing capabilities are scrutinized. These securities continue to be able to provide quality financing arrangements for community banks that want to grow their communities.

**Regulators should use this exercise to further simplify Basel III.** Regulators should consider further simplification of Basel III beyond the CBLR. For example, the amount of the allowance for credit losses, both today and after CECL is implemented, that can be included in regulatory capital is capped at 1.25 percent of risk-weighted assets with the eligible amount confined to tier 2 capital. The loss-absorbing capabilities of the allowance should be recognized by the federal banking agencies as another layer of deposit insurance fund protection by allowing the entire allowance to be captured in regulatory capital both under the Basel III capital framework that exists today and the CBLR. For the Basel III framework, the allowance amount up to the first 1.25 percent of risk-weighted assets should be included in common equity tier 1 capital with the remainder included in additional tier 1 capital.

ICBA appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at (202) 821-4364 or james.kendrick@icba.org.

Sincerely,

[redacted]

James Kendrick
First Vice President, Accounting and Capital Policy

[2] Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act effectively "grandfathered" as tier 1 capital trust preferred securities issued before May 19, 2010 by depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009 as well as by organizations that were mutual holding companies on May 19, 2010.



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