National Association of Industrial Bankers

October 22, 2012

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W Washington, D.C. 20551

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

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

Re: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions and Prompt Corrective Action; Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; Advanced Approaches Risk-based Capital Rule. Federal Deposit Insurance Corporation: RIN 3064-AD95, 3064-AD96, 3064-AD97; Federal Reserve System: Docket Nos. R–1430, R-1442; RIN 7100-AD87; Office of the Comptroller of the Currency: OCC-2012-0008, OCC-2012-0009, OCC-2012-0010; RIN 1557-AD46*

Dear Secretaries Johnson and Feldman and To Whom It May Concern:

The National Association of Industrial Bankers (NAIB)[1] is pleased to provide comments on the three Notices of Proposed Rulemaking published by your agencies to revise current risk-based and leverage capital requirements consistent with agreements reached by the Basel Committee on Banking Supervision entitled "*Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*" (hereinafter collectively referred to as "the proposals").

[1] First chartered in 1910, industrial banks operate under a number of titles; industrial banks, industrial loan banks, industrial loan corporations, thrift and loan companies. Industrial banks provide a broad array of products and services to customers and small businesses nationwide, including some of the most underserved segments of the U.S. economy. NAIB members are chartered in California, Nevada and Utah.

NAIB supports the overarching goal of the global Basel process to ensure that capital requirements for U.S domiciled and foreign banks are sufficient to withstand and help prevent prevent future financial crises. However, we have a number of concerns with the proposals as drafted. While our comments focus on the impact on industrial banks, their parent companies and their customers, we share the common concerns of financial institutions of all types.[2]

Industrial banks are a type of insured depository that may be owned by non-financial parent companies. Because of their non-traditional ownership industrial banks have a unique ability to remain well-capitalized.

Policy Concerns

The proposals have a laudable goal. They are intended to provide a uniform capital standard for banks in multiple nations, link capital adequacy to risks inherent in a bank's assets, and minimize the risk of failure due to inadequate capital or liquidity.

We believe, however, taking into account the enormous and growing diversity of banks and financial markets nationally and around the globe, that a single formula cannot reasonably anticipate and address every risk faced by every bank and is more likely to constrain innovation. The differences between an industrial bank, a Spanish *caja,* a global bank deemed an FISI, a German *sparkassen* and a small U.S. community bank are just too great to be properly regulated under a single set of comprehensive standards.

At first glance, the logic of risk weighting is appealing and we understand why Congress and regulators have striven to develop a good risk weighting formula for bank capital over the past 20 years. But today we tend to agree with the growing number of knowledgeable regulators, bank officials, and analysts that have begun to question whether risk weighting can work as a means to set uniform capital standards for banks.

As a general rule, a "one size fits all" approach only works if it covers things that are one size. For example, it is well settled that cash and U.S. government securities present zero risk of loss. It is hard to imagine any circumstances where that would not be the case. But when the weightings expand to cover things that are not one size, and change from time to time, the result can be damaging and counterproductive.

A risk weighting approach only works well if it accurately measures risk. The risk profiles of many things covered in Basel III vary from time to time and bank to bank. Locking a risk weighting for a particular asset into law or regulation can affect the origination of those assets if the real risk changes or is different. In a worst-case scenario it can unnecessarily increase the cost of credit or effectively end offering certain kinds of credit altogether, or conversely, it can

[2] Industrial banks are a type of insured depository institution that may be owned by non-financial parent companies. They are the best capitalized, most profitable, class of banks in the United States.

encourage the growth of assets that present higher risks as they grow. For example, most mortgages originated today present less risk than the more exotic home loans originated in 2006 at the height of the housing bubble. The risk in a few mortgage loans originated by a small bank to well known customers is lower than a pool of loans originated by a mortgage broker trying to meet volume goals. These differences are crucially important. They must be part of the equation for bank portfolios to be properly risk weighted. Inappropriate risk weighting of assets distorts the market and must be avoided.

We are concerned that many of the proposed risk weightings appear arbitrarily harsh in some circumstances. Overall, the increased capital requirements put banks at a significant competitive disadvantage to nonbank competitors offering similar products and services, threatening the value of investing in a bank and therefore banks' access to capital. The current proposal will shift such lending from regulated entities to entities that are either unregulated or less regulated. Alternatively, under the proposals, if lending does not shift to nonbank competitors, the aggregate amount of lending across the nation must decrease, with significant consequences for the nation's economy.

It should be remembered that risk weighting is not the only option for managing risk. That is what bank management and regulators have always done in one way or another. The key to a successful risk control system is identifying, assessing and controlling risk, which includes holding enough capital to prevent failure if the risks should cause losses. Risk weighting to the degree and complexity in the proposed Basel III regulation is more likely to create arbitrary standards that do not identify, assess and manage current risks in any reasonable degree. They simply represent a negotiated number at a single point in time. We submit that a better approach is to set minimum capital standards, identify the few areas where risk weighting is likely to be valid for every bank at any point in time (again, such as cash), and allow regulators to examine the risk control systems in each bank, looking at how well the bank identifies risks and whether it should hold additional capital above the minimum to prevent the bank from failing if losses occur.

NAIB believes that finding the right balance between these competing considerations—if that is possible—is the key to the success of the proposed regulation.

Specific Areas of Concern

The Risk Weighting for Mortgages Will Harm Credit Availability

Increasing the risk weighting for mortgages will be a disincentive for banks to hold mortgage related assets in any form. Additional disincentives include the increased compliance burden for anyone originating a mortgage loan and the uncertainty surrounding the parameters for a "safe harbor" allowing an originator to avoid being required to hold a percentage of every mortgage loan it originates. In combination, it is likely that only the largest banks have adequate resources to effectively offer mortgages. Dealing with the expense associated with the compliance burden will require a high volume of business that smaller banks cannot achieve.

This presents a risk that small banks will be pushed out of the mortgage business and large banks will only offer loans to the most creditworthy borrowers in order to avoid holding receivables requiring increased capital. This will also drive the mortgage business to nonbank originators not subject to bank capital rules, the same "shadow banks" that played such a significant role in the housing bubble in the last decade. Further, and significantly, it will also unduly constrain mortgage lending in the future and prolong the recovery of the housing markets.

The Treatment of Unused Lines of Credit Will Harm Consumer Lenders

One iteration of the rule would change risk weighting for unconditionally cancelable unused credit lines by adding a percentage of those unused lines to the risk weighted assets (other iterations of the new capital rules would retain the current standard that has a zero risk weight for unused credit lines that are unconditionally cancelable). Changing the current standard for unconditionally cancelable unused credit in the final version of the Rule would significantly constrain the availability of all credit lines going forward, a result which will have a disproportionate impact on U.S. banks, especially large credit card issuers.

We understand the ostensible reason for this change is that a number of commercial borrowers tended to draw down credit lines more than usual as the recent recession deepened. At the same time, however, consumers tended to do the reverse. In fact, consumers began paying down credit card balances; a trend which started more than two years ago and continues today.

Many if not most of the commercial lines drawn down during the recession involved commercial loan commitments for which the bank was paid a commitment fee, thus it was contractually required to fund all draws up to the credit limit. If the new rules require holding capital against unconditionally cancelable lines for which no fee is paid, banks will be reluctant to grant lines exceeding expected usage, which will reduce the availability of credit and spending.

Commercial lines that are not unconditionally cancelable are already risk weighted under current capital rules and that would not change under Basel III. Credit lines that are unconditionally cancelable present far less risk than the non-cancelable commercial lines. A bank will fund increased draws on unconditionally cancelable lines only if it has the liquidity and capital to support the new receivables. If it is stressed it will simply cancel or reduce the lines. Our members report many instances of unused credit lines being cancelled during the recent downturn. NAIB does not believe there is any justification for this proposed increase in the risk weighting of unconditionally cancelable unused credit lines and recommends eliminating this proposed change from the final regulation.

The proposed rules Impose An Undue Burden on Smaller Industrial Banks

NAIB is concerned that the complexity of the Proposals imposes unnecessary compliance burdens, with smaller institutions bearing a disproportionate cost. The proposal fails to adequately match the complexity of the rules to the complexity of each bank.

This burden also inhibits long term planning for all banks as they try to fathom what the proposals say and mean as well as to infer meaning from what they do not say. In effect, risk weightings and the burden in calculating capital requirements have become in themselves a major risk factor in business planning for banks.

Complex, uncertain and excessive capital requirements will limit access to capital

A growing number of impediments to investing in U.S. banks has constrained and distorted the growth of the industry. These impediments already include, among other things, the Volcker Rule and restrictions on activities of traditional bank holding companies. The effect of these restrictions can be seen in the fact that, at the end of the Second World War, U.S. banks provided the majority of all credit in the U.S. economy but in 2008 banks' share of credit had declined to about 20%.

In addition to constraining investment in banks, these restrictions favor shell holding companies with little or no ability to provide capital to the bank subsidiary since those holding companies can only engage in activities closely related to banking. These companies will soon have more extreme restrictions on how they can invest any cash or other investments they may hold when the "Volcker Rule" goes into effect. These restrictions apply to any entity directly or indirectly owning 5% or more of the voting shares in any traditional bank. This has limited the ability of all but the largest traditional U.S. banks to obtain capital from institutional investors and promotes the development of the largest banks at the same time that the government is considering ways to reverse that trend.

The complexity, uncertainty and prospect for increased capital requirements will aggravate these problems and make it even harder for banks to attract capital. While these considerations do not outweigh the importance of safety and soundness, the ability to attract capital is also a crucial consideration that is too often given inadequate attention when setting bank capital requirements.

The industrial banks present a compelling case for the benefits of removing rather than adding to the restraints on investing in banks. The United States is the only member of the G20 that prohibits commercial companies from owning banks. Under the rubric of preventing the mixing of banking and commerce, activity restrictions in the Bank Holding Company Act serve as a barrier to the formation of new capital in banks.

In virtually all other nations, strong, diversified parent companies, often in a better position to provide capital as needed to restore balance sheets depleted by loan losses or to support new growth, may own banks. It has been estimated that the net worth of U.S. non-financial corporate businesses exceeds $13 trillion. If some of this capital were invested in industrial banks (or if the overall restrictions on limiting banking and commerce were lifted for all types of banks), it would contribute to an expansion in the availability of credit.

As the eminent banking scholar Dr. James Barth observed in 2011:

> *These ownership restrictions place the United States out of step with most countries around the world. According to World Bank data, only four of 142 countries surveyed prohibit the ownership of banks by commercial firms. Most importantly, this restricts the ability of the U.S. banking industry to draw upon the substantial equity of commercial firms. This, in turn, limits the ability of the U.S. banking industry to enlarge its capital base and thereby to maintain its role as a major player in the increasingly competitive global banking industry.*[3]

In an economy that is primarily driven by credit, what we need is a robust public policy debate on the changes in capital standards and investment requirements that would allow our nation's banks to unrestricted access to new sources of commercial and private equity.

Increasing Capital Requirements For Bond Portfolios Is Unnecessary

The Proposals would include unrealized gains and losses on available for sale ("AFS") securities in regulatory capital. We understand that the proposed treatment of AFS securities reflects an attempt to recognize potential credit losses in regulatory capital. While this may be a desirable policy goal, the Proposals would introduce new risks to banks in several ways, risks which, we believe, outweigh any benefits obtained.

First, the proposed capital treatment is pro-cyclical. It may result in increased capital requirements at times of greater distress, which may unhappily coincide with increased capital requirements derived from the imposition of the counter-cyclical capital buffer requirement of Basel III. Certainly, it will increase capital volatility, with implications on banks' access to the capital markets. Second, it may push banks to shorten the duration of their investment portfolio, at the expense of earnings. Third, it may result in banks increasing their holdings of held-to-maturity securities, which would decrease banks' balance sheet flexibility or ability to address interest rate risk. Lastly, these bonds, whose value will decrease if they are eschewed by banks, are often long-term government, housing agency or public infrastructure bonds—sectors which remain problematic in today's weak economic recovery

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[3] James R. Barth and Tong Li. "Industrial Loan Companies: Supporting America's Financial System." Milken Institute (April 2011): 5 The Study found that along with the U.S., only Fiji, Guernsey and the Isle of Man prevent commercial ownership of banks: 35

Further restrictions on Deferred Tax Assets

The Proposals disallow deferred tax assets ("DTAs") that arise from tax loss carry-forwards or tax credits, which we agree is reasonable. Further, the Proposals maintain the same ratio of allowable DTAs which arise from temporary timing differences. However, amounts that aren't disallowed are subject to a risk-weight of 250% in the Proposals. We believe this is an unnecessary hardship for banks. For most banks the single largest component of DTAs arising from temporary differences is the Allowance for Loan and Lease Loss ("ALLL"). Therefore, a bank must charge capital for its ALLL through the income statement and then potentially have further deductions from capital for the DTAs that arise by virtue of the ALLL.

NAIB believes this proposal could be made more reasonable if the risk-weight were lowered from 250%, perhaps to 150% (we acknowledge the increased risk of DTAs). In addition, the amount of the ALLL included in Tier 2 capital could be increased from 1.25% of gross risk-weighted assets to 1.5% or 2%. In this way a bank is given additional credit in its capital for the ALLL.

Risk Weighting Past Due Loans Duplicates Loss Reserves

Some new risk weightings duplicate other prudent mitigation measures and are unnecessary. One example is the proposed new risk weighting for past due and non-accrual loans. Those risks are already covered by the higher levels of loan loss reserves typically maintained for these loans, which impacts capital through provision expense. Adding new risk weighting requirements would incur an additional and unnecessary impact on capital.

New Liquidity & Funding Ratios Should Recognize Practices Unique to the U.S.

The proposal also contains two new liquidity standards—the Liquidity Coverage Ratio and the Net Stable Funding Ratio. The former requires banks to maintain sufficient liquidity to meet net cash outflow over 30 days while the latter requires banks to maintain stable sources of funding relative to illiquid assets and contingent obligations over a one-year period.

NAIB believes it is essential that the agencies define "stable" and "less stable" deposits before imposing liquidity ratios and thus avoid putting U.S. banks at a disadvantage. The introduction of the term "stable deposits" is new to the banking lexicon. In the United States, policy discussion has focused on whether deposits are "core" as an indicator of stability.

Among nations with deposit insurance programs, U.S. banks uniquely have access to insured brokered deposits. These have proven to be among the most stable and reliable source of deposits available to banks. Unlike traditional core deposits, brokered deposits are not susceptible to a run. Brokered certificates of deposit cannot be terminated before maturity except in the case of the death of the depositor or adjudication of mental incompetency, and in practice are almost always held to maturity with less than 1% being redeemed early.[4]

Many industrial banks effectively "match fund" new loans with brokered deposits. Deposits in the form of brokered CDs are issued at terms matched to the expected life of new loans. Loan payments are the primary source of funding to pay maturing CDs. In addition, most industrial banks do not offer checking or other transaction accounts, thereby significantly reducing liquidity risk. As a result, most industrial banks have significantly lower liquidity demands than a bank that offers checking and other transaction accounts.

NAIB believes that the agencies should deem brokered deposits as stable when calculating these ratios and provide a means to adjust liquidity requirements for banks according to their specific profile. This is another area where one size does not fit all and the resulting misfit will be counterproductive and unnecessarily damaging to many industrial banks.

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We reiterate our support for reasonable capital standards, the goal of which is to avoid future economic crises of the type our nation recently experienced, however we believe these proposals simply go too far. The Proposals increase capital ratio requirements and simultaneously decrease the numerator and increase the denominator used to calculate those ratios. The net result is a damaging combination to banks that will decrease credit availability and/or disadvantage banks in favor of the "shadow" banking industry. Further, another outcome is an increased consolidation of banking activities into the largest banks. We believe these results are not desirable for the country as a whole.

We look forward to working with your agencies. I would be happy to discuss our views in more detail. I may be reached at (801) 355-9188 or frank@fputah.com.

Respectfully Submitted,

Frank Pignanelli

Frank Pignanelli
Executive Director

[4] See: "FDIC Core and Brokered Deposit Study as Mandated by Section 1506 of the Dodd Frank Wall Street Reform and Consumer Protection Act" (July 8, 2011) which found: "When brokered deposits are used as a substitute for non-core bank deposits and other bank liabilities, brokered deposits do not have a statistically measurable effect on the probability of bank failure, provided the bank's leverage ratio, asset growth and nonperforming loan rate remain unchanged." 69