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BANKING, HOUSING, AND URBAN AFFAIRS
BUDGET

United States Senate

WASHINGTON, DC 20510

December 5, 2012

Hon. Ben Bernanke, Chairman
Federal Reserve Board
20th Street and Constitution Avenue NW
Washington, DC 20551

Hon. Thomas Curry
Comptroller of the Currency
Department of the Treasury
Washington, DC 20219

Hon. Martin Gruenberg, Chairman
Federal Deposit Insurance Commission
550 17th Street, NW
Washington, DC 20429

Dear Messrs. Bernanke, Curry, and Gruenberg:

As you know, I have been a strong advocate for robust reform of the financial sector, whose stability is so critical to the deployment of capital to families and businesses. Even within industry, few would argue with the need to increase and improve the capital that funds financial firms and is available to absorb unexpected losses. While capital cannot replace the need for other critical regulations, neither can other regulations replace the need for good quality capital. Both are critical to ensure that banks can weather storms and keep providing the loans and services that families and businesses need to keep the economy moving forward.

The series of rules proposed recently by your agencies on capital (the Basel III Rules) address a number of weaknesses that came to light during the financial crisis. However, I believe there are several areas where the Basel III Rules could benefit from additional tailoring and flexibility, specifically for community banks, while preserving the core principles of more and better capital.

Community banks serve a diverse range of underserved populations, from rural areas of Oregon to minority neighborhoods in cities like Portland. They have varied business models, although most engage in only "plain vanilla" lending. Ensuring that capital rules – especially risk-weighted charges and similar deductions – work for the varied environments in which community banks find themselves is critical to ensuring that they can make the loans and provide the services that Oregon families and businesses need.

Oregon community banks have brought to my attention a number of concerns with the Basel III Rules. These matters involve critical components of how community banks do business. I urge you to give serious weight to their concerns and protect their ability to make the import contributions to our Main Street economies that they do every day.

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First, community banks highlight how the lack of grandfathering outstanding trust-preferred securities is fundamentally unfair because those instruments were issued under previously prevailing market expectations. Indeed, the Collins Amendment of the Dodd-Frank Act specifically addressed this concern for already outstanding trust preferred securities by providing for a reasonable transition period. Regulators should respect that transition period.

Oregon community banks have also expressed concern about the requirement that the unrealized gains and losses from the available-for-sale portfolio flow through to capital and about the treatment of mortgage servicing rights (MSRs). Here, the community banks highlight how these regulatory changes increase their capital exposure to market volatility related to interest rates, even when they aren't incurring actual losses. For MSRs, the proposed rules are particularly frustrating if those MSRs come from simply having originated mortgages with an intention to maintain the customer relationship.

Many community banks have also raised concern with higher risk-weighted capital charges for certain commercial real estate and mortgage loans. These may be particularly challenging for community banks in rural areas and more underserved communities.

Capital issues are complicated, the trade-offs are real, and the devil is in the details. I urge you to carefully consider the concerns raised by community banks and ensure that under the new final rules community banks will continue to be able to provide the plain vanilla lending that has made them the backbone of many Oregon communities. I'm pleased to see that regulators are engaged in reflection on these matters, with Comptroller Curry's October 23 speech being a good example.

In addition, I encourage you to evaluate changes based on how they relate to community bank practices and risk. Should it be appropriate to provide accommodations based on size, I would urge you to consider gradually scaling your approach rather than applying a hard cut off at one particular number such as $10 billion. Fairness also requires that larger rivals not maintain a competitive advantage over community banks because large banks are able to operate on a thinner capital buffer. A recent estimate by Americans for Financial Reform suggests that even after Basel III is implemented, the nation's largest banks may operate with two to four percentage points less in Tier 1 capital than most community banks. This suggests that Americans for Financial Reform, the Better Markets Foundation, and the Pew Systemic Risk Council are right in arguing that the Basel III Rules for the largest and most systemically interconnected banks should be even stronger.

I encourage you to continue to listen carefully to the concerns of all, including both reform advocates and the financial industry, and to do the right thing based on sound analysis and experience. These matters are complex and strong capital rules are important to ensure the financial stability and protect the economy, but you can and should appropriately tailor the rules to accommodate the needs of community banks without compromising the purposes. I look forward to working with you towards that goal.

Sincerely,

Jeffrey A. Merkley

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