Federal Advisory Council

On September 14, 2012, the Federal Advisory Council met with the Board of Governors to discuss the joint notice of proposed rulemaking on regulatory capital requirements (Docket No. R-1442). The Council provided written views, which are provided below.

Basel III NPRs

> **The Board recently released the following notices of proposed rulemaking (NPRs) related to Basel III: (1) the Basel III NPR (quality and quantity of capital), (2) the Standardized Approach NPR (calculation of risk-weighted assets), and (3) the Advanced Approaches and Market Risk NPR (revisions to the advanced approaches consistent with the Dodd-Frank Act). What are the Council's views on those NPRs and in particular, its views on the magnitude of the change in capital requirements, scope of their applications, implications for the availability and cost of credit, profitability of banking and mix of banking products, volatility of regulatory capital, and transition period for implementation?**

Overview

The Council has serious reservations about the intended and unintended consequences from the proposed Basel III capital requirements. Members support the principle that all banks should have comparable standards, and the amount of capital required should be reflective of the institution's risk. However, making these specific rules applicable to community banks as well as the largest financial institutions, which are required to adopt the advanced approach, has the potential to cause significant disruption to the industry and the overall economy. These rules have the potential to place U.S. institutions at a meaningful disadvantage relative to foreign institutions. The cumulative effect of the significant changes in capital and risk weights should be weighed carefully.

Chief among our concerns are:

- We believe the cumulative impact of these NPRs will have highly negative results to consumers and the economy. We suggest that the regulatory authorities carefully consider whether the end result is an improvement.
- As proposed, certain residential mortgage products will no longer be profitable unless the interest rate charged to the customer increases dramatically to cover the higher capital cost and compliance costs. The expected end result is that many consumers will either have to pay more, do without, or go to the unregulated sector.
- When coupled with the other provisions affecting mortgages – including Qualified Residential Mortgages, restriction on capital treatment for mortgage servicing assets, increase in risk weighting for mortgage loans, implementation of complex rules resulting in an increase in capital required for securitizations – regulated lenders will likely focus only on loans they can sell or securitize with or to Fannie Mae or Freddie Mac. This will only accentuate the concentration of mortgage credit in these institutions and further hinder the resolution of their conservatorship status.
- Capital levels will become more volatile due to the impact of market-value changes in available-for-sale (AFS) investment securities. Most would expect that an increase in

lending accompanies an economic recovery and an increase in market interest rates. However, under the proposed rules the effect of an increase in interest rates will be a reduction in capital, potentially restricting credit and hampering any economic recovery. We believe the existing rules for determining impairment are sufficient for determining whether an adjustment to income, and thus capital, is necessary.

- The cumulative effect of these proposed and other regulatory changes will result in traditional banking becoming even less profitable and investors eventually choosing to put their money elsewhere. Consequently, we expect to see additional consolidation into the largest institutions. Such consolidation is contrary to the goal of reducing concentration risk in financial services and moves the industry in the wrong direction. Consumers will have fewer choices for meeting their credit needs within the regulated sector.
- We believe that the changes to risk weights are not supported by sufficient empirical data or logic. For example, the proposed residential real estate risk weighting could create an incentive to release collateral, which would create an unsecured loan and reduce risk-weighted assets.
- A significant concern at this point is not the transition schedule but the timing of the implementation of the final rule. Many of the new proposed risk-weighted asset calculations, such as for residential mortgage, HVCRE, and bank-book-securitization calculations, require the incorporation of qualitative information at the individual exposure level that, while employed in many risk-management processes, is not readily available in the data-intensive processes required to support the newly proposed capital calculations. In many cases, this qualitative information requires periodic updates. Adapting data processes to incorporate these proposed changes will be an expensive and lengthy undertaking. Any of these changes require careful planning and long lead times to ensure the integrity of the calculations and management of the data.
- The calculation of risk-weighted assets for U.S. banks in the Standardized Approach NPR is not consistent with the risk weightings of these same assets measured by regulatory calculations in other countries. The differences are most pronounced when compared with the risk weightings applied to similar assets of European banks. This dichotomy renders capital and leverage comparisons between U.S. and European banks uneven and useless, placing U.S. banks at a huge disadvantage globally.
- Finally, banks have structured existing portfolios of assets and evolved capital structures that were consistent with existing U.S. application of the rules in Basel I and Basel II. Consideration needs to be given to grandfathering affected assets and liabilities under existing rules or for providing significant transition times in order to adjust these positions in an orderly and positive economic fashion.