October 17, 2012

VIA ELECTRONIC DELIVERY
Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.,
Washington, DC 20551
regs.comments@federalreserve.gov
Docket No. R-1442 and RIN No. 7100-AD87

RE: Regulatory Capital Rules: (1) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Correction Act; and (2) Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements: Docket No. R-1442 and RIN No. 7100-AD87

Dear Ms. Johnson:

The Wisconsin Bankers Association (WBA) is the largest financial trade association in Wisconsin, representing approximately 300 state and nationally chartered banks, savings and loan associations, and savings banks located in communities throughout the state. WBA appreciates the opportunity to comment on the proposed regulatory capital rules proposed by the Board of Governors of the Federal Reserve System (FRB), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies).

WBA is gravely concerned over the broad approach taken by the Agencies to impose a "one-size-fits-all" regulatory capital scheme on institutions of all sizes despite the fact that the industry believed the Basel III proposals were only intended for very large, complex international institutions.

Respectfully, we believe this approach excessively tightens regulatory capital requirements on community banks which is unwarranted, beyond Congressional intent in many respects, and will likely cause a disruption in available credit within the financial industry.

WBA wishes to remind the Agencies that, in addition to the proposed Basel III rules, there are currently at least ten major mortgage related rulemakings in various stages of development (HOEPA, MLO compensation, TILA/RESPA integration, two appraisal rules, ability-to-repay, risk retention, escrow requirements, and mortgage servicing rules under both TILA and RESPA). This, in turn, builds upon at least seven major final rulemakings in the previous 36 months (RESPA reform, HPML requirements, two MDIA implementation rules, appraisal reforms, appraisal guidelines, and MLO compensation).

WBA is very much concerned about the cumulative burden these rules will have on financial institutions—community banks in particular. It is vitally important that the proposed regulatory capital rules be analyzed together in the context of other rulemakings and regulatory reforms—and be prospective in approach. The Agencies must not create capital requirements that are based upon occurrences in the past, under a different regulatory environment, and without consideration of other rulemakings and reforms.

For these reasons and for the concerns outlined below, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms will have on risk. The Agencies must recognize that there are many differences between community banks and large,

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complex international institutions—and must, therefore, not force a community bank into the same capital calculation "peg-hole" as a sophisticated international institution.

If the Agencies do not withdraw the proposals to further study the drastic impact they will have on community banks and on the U.S. financial industry as a whole, WBA urges the Agencies to take into consideration the specific concerns and recommended changes noted below.

Accumulated Other Comprehensive Income (AOCI)

As proposed, all unrealized gains and losses on available for sale securities (AFS) must "flow through" to common equity tier 1 capital. Therefore, if there is a change in the value of an AFS security (which can occur daily in some circumstances), that change must immediately be accounted for in regulatory capital. WBA reminds the Agencies that unrealized gains and losses occur in AFS portfolios primarily as a result of movements in interest rates—and *not* as a result of credit risk.

If the rules are finalized as proposed, with the inclusion of unrealized losses of AFS securities in common equity tier 1 capital, rising interest rates would put downward pressure on banking organizations' capital levels. This will potentially cause a financial institution to reduce its growth or shrink its securities portfolios considerably in order to maintain capital ratios at the desired or required levels.

Additionally, financial institutions—including community banks—have been an investor in their local government entities. However, as proposed, the rules would discourage financial institutions from holding municipal securities, including holding U.S. Treasuries, because of the interest rate impact on such long-duration assets. This, in turn, could lead to a lower return on assets for financial institutions and less funding for the housing market and national and local governments, collectively.

For these reasons, WBA greatly opposes this proposed treatment. The Agencies must remove this treatment from the proposals.

Treatment of Trust Preferred Securities (TruPS)

The Agencies' treatment of trust preferred securities (TruPS) under the proposals must not be finalized as proposed. Presumably out of concern for such a debt instrument being treated as "capital", Congress, as part of the Dodd-Frank Act (DFA), prohibited any new issuances of TruPS; however, under the Collins amendment in DFA, TruPS are grandfathered for institutions between \$500 million and \$15 billion. Nonetheless, the Agencies' proposals ignore the Collins amendment by requiring a complete phase-out of TruPS beginning in 2013.

Many Wisconsin community banks issued TruPS and therefore hold them as capital on their books. The proposed complete phase-out of TruPS creates a significant problem for community banks that are privately held as they will have little access to capital. Investors in community banks are motivated by the growth opportunities such an investment affords rather than a desire to fill capital holes caused by changes in regulation.

WBA strenuously opposes the Agencies' treatment of TruPS beyond that which Congress intended under DFA. The Agencies must preserve the full intent of the Collins amendment to DFA by *permanently* grandfathering outstanding TruPS for institutions between \$500 million and \$15 billion.

Capital Risk-Weights for Residential Mortgages and Related Matters, High Volatility Commercial Real Estate (HVCRE), and Home-Equity Lines of Credit (HELOCs)

The Agencies' proposals place new significantly higher capital risk weights in several categories of real property-secured loans despite having neither empirical evidence to substantiate the need for such heightened capital levels, nor a mandate under law. The proposals raise several significant concerns, including the following.

Residential Mortgage Exposures Risk Weights

The proposals assign risk weights to residential mortgage exposures based on whether the loan is a "traditional" mortgage (Category 1) or a "riskier" mortgage (Category 2) *and* the loan-to-value (LTV) ratio of the mortgage. The current risk weight for a real estate mortgage is generally 50%; however, depending upon the Category and LTV ratio of a particular residential mortgage, the capital risk could rise to 200%. These higher risk weights appear to be arbitrarily set as there is no empirical data presented by the Agencies to support this extraordinary increase in risk weights for certain types of mortgages.

Respectfully, WBA challenges the Agencies' assumption that a residential mortgage has a higher degree of risk based exclusively upon the loan having a balloon payment, an adjustable rate, or an interest-only payment, to warrant the substantial increases in capital risk weights that are proposed. Based upon information shared by WBA members, the Agencies' proposed capital treatment far outweighs the reality of risk that our members have experienced for these types of loans.

In addition, the substantial increase in risk weights will discourage financial institutions from making theses types of loans even though some Wisconsin financial institutions have experienced minimal losses. In Wisconsin many community banks make various types of balloon loans, such as 3- or 5-year balloon mortgages, with payments amortized over 30 years. They provide such loan products in order to offer loans to good borrowers and to protect against interest-rate risk. However, the new risk weights will discourage financial institutions from making such loans. For example, if an institution makes a 5-year balloon loan with a LTV of 81-90%, the capital risk weight skyrockets from the current rule of 50% to 150% under the proposals. This type of treatment will detrimentally impact just how many loans a financial institution can offer its community and customers, will reduce or eliminate a traditional credit product that customers seek, and will also reduce an institution's ability to protect against interest rate risk.

<u>The Agencies must not finalize the proposed rules with such severe and unwarranted risk weighted treatment of residential mortgage exposures</u>.

Reclassification to Category 2 for the Restructure or Modification of Mortgages Unless Made Under HAMP

The proposals would also require a financial institution to re-assess a mortgage after a loan restructuring or modification, unless the modification is made under the federal Home Affordable Mortgage Program (HAMP). Thus, a Category 1 mortgage may become a Category 2 mortgage after modification if the institution does not modify the loan under HAMP. WBA believes this treatment will, in essence, limit an institution's ability to provide an option to restructure or modify a loan except under HAMP. Given today's economy and its impact on any particular borrower, it is imperative financial institutions be given flexibility to restructure or modify *any* given mortgage loan to the particular needs of both the institution and the borrower—including not under HAMP. The financial institution should not be penalized by assigning a Category 2 risk weight to a loan that is modified or restructured in a manner that is not under HAMP.

The Agencies must allow for the same capital treatment of restructuring or modification for any mortgage as they would permit a loan restructure or modification under HAMP.

Removal of PMI Recognition When Determining LTV

The bank's residential mortgage portfolio would also be negatively impacted by the proposed change in treatment of private mortgage insurance (PMI). The proposed rules do not recognize PMI when determining an LTV for a particular loan. Therefore, mortgages would be subject to high risk weights even if PMI reduced the risk of loss for such loans. It is difficult in today's challenging economy for borrowers to come up with a 10% downpayment, much less an amount higher than that, thus, PMI continues to be a product purchased to protect against repayment default risks. WBA recognizes the concerns expressed by the Agencies within the proposed rules regarding less financially-sound PMI providers; however, where a financial institution can demonstrate that a particular PMI provider is financially sound, the instiuttion should be permitted to recognize PMI when determining the particular loan's LTV ratio for capital risk weight purposes.

The Agencies' proposals must recognize that PMI reduces the risk of loss for such loans, and must, therefore, provide for the recognition of PMI when determining a loan's LTV ratio.

Capital Requirements for Loans with Credit-Enhancing Representations and Warranties

Under the proposed rules, if a financial institution provides a credit-enhancing representation or warranty on assets it sold or otherwise transferred to third parties, the institution would be required to treat such an arrangement as an off-balance sheet guaranty and apply a 100% credit conversion factor to the transferred loans while the credit-enhancing representations and warranties are in place. This new requirement would affect any mortgage sold with a representation or warranty that contains (1) an early default clause, and/or (2) certain premium refund classes that cover assets guaranteed, in whole or in part, by the U.S. government or a government-sponsored entity. Currently, the risk-based capital charges do not apply to mortgages once they are sold to third parties, even where the seller provides representations and warranties to take back mortgages that experience a very early payment default—such as within 120-days of the sale of the mortgage.

The proposal would result in substantial additional capital charges for the mortgages financial institutions sell and will limit the amount of credit they can make available to potential borrowers. WBA believes there is little evidence that the temporary representations and warranties associated with these mortgages have resulted in significant losses for a regulated financial institution—even during the financial crisis.

As a result, the Agencies must retain the 120-day safe harbor under the current risk weight rules and not impose this additional capital charge.

High Volatility Commercial Real Estate (HVCRE)

As proposed, high volatility commercial real estate (HVCRE) is defined as acquisition, development and construction (ADC) commercial real estate loans except: (1) One-to-four-family residential ADC loans; or (2) commercial real estate ADC loans in which: (a) applicable regulatory LTV requirements are met; (b) the borrower has contributed cash to the project of at least 15% of the real estate's "appraised as completed" value prior to the advancement of funds by the bank; and (c) the borrower-contributed capital is contractually required to remain in the project until the credit facility is converted to permanent financing, sold or paid in full. Under the proposed standardized approach, each HVCRE loan in a bank's portfolio will be assigned a 150 percent risk weight.

While WBA recognizes the fact that certain types of commercial real estate (CRE) lending may pose a higher risk given today's economic environment, the Agencies' proposals impose a higher risk weight without considering any of the following mitigating factors in connection with a particular transaction: LTV ratio; dollar amount of the loan; other commercial real estate assets of the borrower; any guaranty; or other general risk-mitigating factors of a particular CRE loan request. Just as these risk-mitigating factors are analyzed when financial institutions decide whether to approve or deny a particular CRE loan request, the Agencies must also take these mitigating factors into consideration when assigning a capital risk weight to a particular CRE.

If mitigating factors are not taken into consideration, the proposals would likely restrict credit for CRE lending. Therefore, <u>the Agencies must revise their proposed HVCRE risk weight to take into consideration risk-mitigating factors</u>.

Home-equity Lines of Credit (HELOCs)

The proposal classifies all junior liens, such as home-equity lines of credit (HELOCs), as Category 2 exposures with risk weights ranging from 100 to 200%. In addition, a financial institution that holds two or more mortgages on the same property would be required to treat *all* the mortgages on the property—even the first lien mortgage—as Category 2 exposures. Thus, if a financial institution that made the first lien also makes the junior lien, the junior lien may "taint" the first lien thereby causing the first lien to be placed in Category 2, and resulting in a higher risk weight for the first lien. By contrast, if one financial institution makes the first lien and a different institution makes the junior lien, then the junior lien does not change the risk weight of the first lien. There is one exception to this general treatment; however, that exception is very narrow and thus, most junior lien mortgages will likely be deemed Category 2 mortgages.

Again, this is another area within the proposals for which the Agencies have provided no data to support their assertion that all HELOCs are risky and warrant such severe treatment. In reality, HELOCs are carefully underwritten—based not only on the value of the home, but upon the borrower's creditworthiness and with some of the strongest LTV ratios.

<u>The Agencies must remove the treatment that all HELOCs are an automatic Category 2 classification.</u>

Definition of Securitization Need Be Narrowed and Clarified

The standardized approach proposal defines "securitization exposure" broadly as "an on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arise from a traditional securitization or synthetic securitization (including resecuritizations)." The definition includes any exposure that "directly or indirectly references" such a securitization exposure. WBA is concerned over how this definition will impact financial institutions who are participating in programs such as Federal Home Loan Banks' (FHLBanks') Acquired Member Assets (AMA) Programs which operate under the names Mortgage Partnership Finance (MPF) Program and the Mortgage Purchase Program (MPP).

These programs are very popular with smaller financial institutions because they provide an alternative to the traditional secondary market that can be difficult or prohibitively expensive for many community lenders to access. According to information gathered from FHLBank of Chicago, nearly 150 financial institutions in Wisconsin have used the MPF Program to provide over $25 billion of mortgages to help their low- and middle-income consumers buy a new home or lower the costs of their existing home loan through refinancing.

The AMA Programs are a unique risk-sharing structure that allow participating members to retain a significant portion of the credit risk of the conventionally underwritten, fixed-rate mortgages they originate. FHLBanks buy the loans and hold them on their balance sheet, managing the interest rate risks. Allocating the risks in this manner results in a more efficient and lower-cost mortgage financing which benefits the homebuying customers of an FHLBank member.

To achieve the risk-sharing, the structure of several AMA products requires a participating FHLBank member to provide a credit enhancement of a defined portion of a pool of residential mortgage loans that have been sold to an FHLBank. Even though the loans are held on the balance sheet of an FHLBank, the participating member must hold risk-based capital against its off-balance sheet credit enhancement obligation. As we understand the proposed rules, the amount of risk-based capital required for participating members would increase for some MPF Products and decrease for others, depending upon the product used.

Under the proposed rules, there are three possible definitional paths for a participating member's credit enhancing obligation in the AMA Programs: (1) traditional securitization; (2) synthetic securitization; and (3) retail exposure. Based upon FHLBank of Chicago's analysis, a member's credit enhancement required under the MPF Program would likely fall into the "synthetic securitization" definition and resulting methodology. This synthetic securitization category could be viewed as one of higher-risk which, in turn, would necessitate a significant increase in capital for financial institutions—including community banks—than that which is currently required.

In essence, the proposed rules would virtually eliminate the existing regulatory approach for risk-based capital that has been in place since inception of the MPF Program in 1997. In its place, the proposed rules would implement a much more complicated formula that would increase the required amount of risk-based capital in many instances. Further, the added complexity of the proposed rules is likely to deter many smaller financial institutions from originating traditional mortgages for sale in the secondary mortgage market. WBA believes the added regulatory burden of the proposals, combined with other new regulations from the Agencies and others, is likely to overwhelm smaller institutions with limited resources and personnel. WBA fears many such institutions may simply exit the mortgage origination market—a consequence we do not believe the Agencies intended.

The Agencies must narrow and clarify the definition of securitizations to provide financial institutions greater guidance as to the breadth of securitization exposures subject to the Agencies' proposals. Additionally, the Agencies must grandfather existing MPF Program pools and other similar programs by assigning them the current capital risk-based weights.

Eliminate 2.5% Capital Conservation Buffer

The Agencies have proposed that financial institutions would be required to hold common equity tier 1 capital in excess of their minimum risk-based capital ratios by at least 2.5 percent of risk-weighted assets in order to avoid limits on capital distributions and certain discretionary bonus payments to executive officers. This requirement would apply to dividend payments, discretionary payments on tier 1 instruments, and share buybacks.

Although WBA recognizes that the capital conservation buffer has been endorsed by the Basel Committee as part of the International Basel III, we believe once the buffer is implemented, it will function as a de facto minimum capital requirement. We believe this additional buffer excessive and unnecessary given the fact that there are other areas of regulatory oversight which monitor and determine when a financial institution is permitted to make a payment to its executives and others, such as 12 CFR 359 regarding golden parachute and indemnification payments. We believe these existing regulations are the appropriate manner in which the Agencies can monitor whether a particular distribution is appropriate given a financial institution's specific circumstances.

WBA is also concerned that the dividend restrictions do not address capital distributions made by financial institutions that are organized under the IRS Code as a Subchapter S corporation (S-corp). These institutions do not pay income taxes directly, but pay the tax liability through to the institution's shareholders in accordance with the shareholders' percentage of ownership. This payment is then used by the shareholders for the purpose of paying income tax the shareholder owes as a shareholder. In essence, this restriction will negatively impact the institution's ability to pass the income tax liability to shareholders through the S-corp, which will, in turn, negatively impact the institution's ability to service any existing holding company debt and the ability to borrow for future growth. Thus, the Agencies' proposal, in effect, penalizes a financial institution simply because of its elected business structure.

For these reasons, the Agencies must eliminate the 2.5% capital conservation buffer from their proposals; however, if the Agencies are unwilling to do so, at minimum they must craft an exception for the S-corporation dividend payments.

Existing Mortgage Loans Should be Grandfathered

Finally, the proposed rules do not include any type of grandfather provision. Thus, *all* mortgage loans currently on the financial institution's books will be subject to the new capital requirements. This will require institution staff to examine old mortgage underwriting files to determine the appropriate category and LTV ratio for each mortgage. This is a daunting task and comes at a time when the industry is also implementing numerous other *substantial* regulatory revisions and reforms previously mentioned. Financial institutions—especially community banks—simply do not have resources necessary to gather all of the information required to properly determine the revised risk weights for existing mortgage loans.

The Agencies must grandfather all existing mortgage exposures by assigning them the current general capital risk-based weights.

Conclusion

For the concerns outlined above, the Agencies must withdraw the proposed regulatory capital rules, conduct additional study and analysis, and only propose capital rules which take into consideration the impact other regulatory proposals and reforms have on risk.

The Agencies must recognize that there are many differences between community banks and large, complex international institutions—and must, therefore, not force a community bank into the same capital calculation "peg-hole" as a complex international institution.

Once again, WBA appreciates the opportunity to comment on the Agencies' proposals.

Sincerely,

Rose Oswald Poels

Rose Oswald Poels
President and CEO

CC: Wisconsin Congressional Delegation
Matt Feldman, FHLBC