On November 2, 2012, the Federal Reserve Board met with the Community Depository Institutions Advisory Council ("the Council"), an advisory group established by the Board to provide input on the economy, lending conditions, and other issues of interest to community depository institutions. The Council discussed the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act and presented its views on the joint notice of proposed rulemaking on regulatory capital requirements, including how certain provisions in the proposal might affect commercial real estate and other types of lending by community banks. In particular, Council members said the proposed risk weights for home mortgage products were not properly aligned with underlying risk, and they noted the resulting strain on banks' net interest margins, particularly in light of rising compliance costs and litigation risks. The Council also submitted written comments, which are provided below. The viewpoints expressed are solely those of the Council.

**Basel III Capital Proposals**

Council members are deeply concerned about numerous aspects of the recent Basel III proposals. These proposals fundamentally change every aspect of regulatory capital—narrowing what counts as capital, changing risk-weight calculations, and establishing new required levels of capital. The Council supports the notion of capital reform to help ensure capital adequacy and better alignment of capital with business risks and incentives. However, the Council believes the current proposal falls significantly short of these objectives and would be particularly detrimental for the community banking segment.

The consequences of not getting Basel III right are significant for community institutions. Institutions such as those represented on the Council are particularly sensitive to the risk of being caught short by the regulators and put in the harmful reputational box of being "undercapitalized." Given the potentially severe supervisory consequences of holding too little capital, community banks often hold more capital than might ultimately be required. As a result, even though the existing well-capitalized standard is 10 percent total capital to risk-weighted assets, community banks often manage themselves well above the existing capital standards to provide a regulatory buffer because of their reliance on retained-earnings management for capital compliance.

If a bank falls short of the new capital requirements, or of its own internally determined buffer above the new capital requirements, it generally has the following three options:

First, it could raise new capital. Large banks with access to national credit markets can more easily issue new capital instruments to meet the regulatory demands. Community banks lack access to national credit markets and are often unable to raise new capital.

Second, a bank could grow capital through its earnings. However, this is a challenging option given higher operating expenses resulting from the Dodd-Frank Act and ongoing national...
economic stress. Moreover, the inclusion of unrealized gains and losses would increase capital volatility and make it unclear how much a bank should be retaining.

Third, if a bank is unable to retain earnings or raise new capital, the bank can increase its capital-to-assets ratio by shrinking the bank. Shrinking the bank hurts customers and it hurts communities. The vital role community banks play in their communities would be hampered if loans become more expensive and more difficult to obtain.

Below is a list of concerns that the Council would like to highlight. U.S. banking services are provided by a diverse industry and the proposals are extremely complex. Because different institutions are impacted by different provisions and in different ways, this is not an exhaustive list.

**Mortgage treatment:** The Standardized Approach NPR assigns different risk weights to residential mortgage exposures based on (i) whether the mortgage is a first-lien “traditional” mortgage as redefined by the rule (category 1) or not (category 2); and (ii) the LTV ratio of the mortgage. Risk weights for category 2 mortgages range from 100 percent to 200 percent, with higher risk weights depending on higher LTV ratios.

The Council believes the categories are inappropriate because they do not focus on an appropriate and necessary consideration of all essential and compensating facts essential to underwriting decisions, whereas community banks excel in this area. If the proposals were to be finalized in current form, the regulators would be encouraging a check-the-box approach to mortgage lending rather than allowing community banks to exercise their judgment about risk factors and the relationship they have built with a potential borrower. The Council feels that the proposals would hurt, rather than help, the residential mortgage market because they do not accurately reflect the actual or relative risk of certain types of residential mortgage loans.

Moreover, the treatment of second mortgages is highly inappropriate. Under the proposal a junior-lien mortgage extended by the same institution that holds a first-lien mortgage on the same property would increase (possibly dramatically) the required capital for the first-lien mortgage.

Finally, the Council would like to emphasize that most community banks do not have the data in their systems to even apply the complex mortgage treatment. As a result, we do not feel it should be adopted as proposed.

**Unrealized gains and losses flowing through capital:** Under the proposed rule, unrealized gains and losses on available-for-sale securities will flow through to regulatory capital. Unrealized gains and losses occur in an available-for-sale portfolio primarily as a result of movements in interest rates. This change would bring interest rate risk into the regulatory capital standards and greatly increase the volatility of banks’ capital ratios. In addition to bringing volatility into the capital calculation, allowing unrealized gains and losses to flow through could create profound risk-management issues (both liquidity and interest rate) and complicate banks’ management of their lending and investment limits. As a result of the volatility and the potential risk-management issues, the proposed rule should be revised so that unrealized gains and losses on available-for-sale securities do not flow through capital.
Phaseout of Trust Preferred Securities (TPS): Inconsistent with the intent of the Collins Amendment, Basel III does not maintain grandfathered-status TPS for institutions between $500 million and $15 billion. Instead, Basel III requires the phaseout of these instruments for bank holding companies having between $500 million and $15 billion in total consolidated assets. In light of the costs of the Dodd-Frank Act and this NPR, all community institutions face greatly reduced alternatives in raising capital. This is particularly true for privately held banks, mutually owned institutions and Subchapter S Corporations. Phasing out this source of capital especially burdens community banks in their capital plans. As a result, the proposed rule should be revised to fully recognize the intent of the Collins Amendment by permanently grandfathering outstanding TPS for institutions between $500 million and $15 billion.

Treatment of Delinquent Loans: Nonresidential loans delinquent over 90 days are risk-weighted at 150 percent. The new risk weighting will often eliminate any incentive to pursue loan workouts, as foreclosure or sale will be the more effective path to take.

Credit Enhancing Representations and Warranties: Banks that transfer mortgages off their balance sheet through sale often guarantee that the mortgages will not default within 120 days. Current risk-based capital rules do not apply a capital charge on these types of short-term arrangements. The regulators have proposed a new capital requirement whereby the guaranteeing bank would need to hold capital against the guaranteed mortgages while the short-term guarantee is in place. There is little evidence that the temporary guarantee associated with such “pipeline mortgages” have resulted in significant losses for regulated banking organizations, even during the financial crisis. As a result, we urge the banking agencies to retain the 120-day safe harbor in the current rules.

Treatment of Mortgage Servicing Assets: Under the proposals, mortgage servicing assets (“MSAs”) includable in regulatory capital would decrease from the current 100 percent of tier 1 to 10 percent of tier 1 common equity, which would be a significant drop for those banking organizations with retail mortgage servicing operations.1 As a result of the proposed deduction, banking organizations would in many cases be significantly more inclined to sell loans with servicing rights released rather than retain servicing.

Community banks are relationship bankers. They often maintain the servicing rights on mortgage loans they sell to maintain customer relationships. The proposed deductions will significantly increase the cost of maintaining those relationships. It is unsound for the banking agencies to discourage long-term relationships: MSAs should not be deducted at any threshold.

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1This is before the overall 15 percent limitation on the combined balance of includable MSAs, deferred tax assets, and investments in the common stock of financial institutions.