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October 22, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AD95 and RIN 3064-AD96
Via email at comments@FDIC.gov

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551
Docket Nos. R-1440 and R-1442
Via email at regs.comments@federalreserve.gov

Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 2-3
Washington, DC 20219
Docket ID 2012-0008 and 0009
Via email at regs.comments@occ.treas.gov

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; and Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements

Dear Sirs/Madam:

The California Bankers Association ("CBA") offers these comments to the proposals by the Federal Reserve Board, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (collectively, the "Agencies") implementing the requirements of the 2011 international Basel III Accord and the "Standardized Approach" for the weighting and calculation of risk-based capital requirements under the prior Basel II Accord (the Basel III and

Standard Approach proposals will sometimes collectively be referred to as the "Proposals"). The Proposals also incorporate aspects of Basel III (the "advanced approaches") that would apply only to the very largest banking organizations. CBA will not offer comments on the advanced approaches.

CBA is the major state trade association for FDIC-insured depository financial institutions that do business in California. We represent banks and savings associations in all asset categories, from local community banks to the largest financial institutions in the country. CBA and its members absolutely concur that banks need to maintain capital standards sufficient to absorb potential losses and weather economic downturns. In recent years, many banks have gradually built up capital, under the supervision of their supervisors, to levels well above current requirements. We recognize that the Agencies have developed the Proposals with a mind to improve the quality and, in some instances, the quantity of capital..

The stated purposes of the Basel III Proposal are to strengthen the quality of banking organizations' regulatory capital as well as increase the quantity of capital to enhance its loss-absorbing capacity. Basel III as conceived by the Basel Committee is intended to apply only to large, internationally active banking organizations. Among other things Basel III creates a new regulatory capital component called Common Equity Tier 1 ("CET1") capital, requires the inclusion of most "accumulated other comprehensive income" ("AOCI") in the definition of regulatory capital (including unrealized gains and losses on available for sale securities), and deducts mortgage servicing assets and certain deferred tax assets from capital. The Basel III Proposal also imposes a new requirement on banks to maintain a capital conservation buffer that consists of additional CET1 capital in an amount above 2.5% of total risk-weighted assets. If a banking organization's capital conservation buffer falls below this threshold, limits in capital distributions and discretionary bonus payments are triggered.

The Standardized Approach Proposal is intended to raise the quality of banking organizations' assets by applying a more sensitive calculation of capital to encourage prudent lending and other practices. These changes in the aggregate will require most banking organizations covered by the Proposals to comprehensively review the capital charges for their assets. The Standardized Approach Proposal increases the amount of capital required for several asset classes, including certain higher-risk construction and commercial real estate loans, all but "plain vanilla" residential mortgages, and past due loans. As a result, a banking organization's capital planning process will require more information than is necessary to satisfy the existing capital rules.

**General Comments**

The Agencies have determined to apply both the Basel III and Standardized Approach Proposals to all U.S. banks and their holding companies, other than the smallest non-complex bank holding companies (generally, those with under $500 million in consolidated assets who are subject to the Board's Small Bank Holding Company Policy Statement). The Proposals would be the most substantial changes to U.S. capital standards in a generation and will have significant and immediate impact on covered banking organizations. The highly-complex Proposals will place disproportionately heavy burdens on smaller covered banking organizations that have not had the experience of employing the recordkeeping and tracking systems necessary to perform the calculations and classify assets necessitated by the Proposals. We understand why the Agencies may be motivated to broaden the application of the capital standards, but we question whether doing so may generate more harm than good to covered entities, consumers, and the economy at large.

Due to the broad scope of the Proposals and their impact on banking organizations and on many of their key business lines, our primary recommendation is for the Agencies to withdraw the Proposals and re-examine these impacts more fully before proceeding. But if the Proposals or parts thereof are adopted, then we ask that the Agencies consider the more specific changes discussed in this letter.

The Proposals come on the heels of the Dodd-Frank Act and its myriad of regulations, which include some of the most broad and stringent regulatory initiatives taken in recent history in response to the financial crisis that began in 2008. This on an industry that, despite the popular press, the Agencies are well aware is already among the most highly regulated of all businesses. Many of the over 200 regulations required to be developed by the Dodd-Frank Act are yet to be written. While the industry today is well on its way to recovery, banks still face numerous challenges, including sluggish loan demand and regulatory restrictions on traditionally important sources of fee income.

As a consequence, many banks still find it increasingly difficult to generate adequate earnings, which are vital to their long term capital formation goals. The Proposals will make it more costly to make loans because those activities will require more capital. Banks may be forced to respond by restricting the availability—or increasing the cost—of credit in the course of complying with new capital standards, to the detriment of their customers and the economy generally. Another consideration that cannot be overlooked and that goes directly to the core of the Proposals is the real and practical difficulty that many smaller banking organizations face raising capital. The Proposal to extend Basel III and the Standardized Approach beyond their intended constituents will exacerbate that challenge.

**Specific Comments (Basel III Proposal)**

<u>Available For Sale ("AFS") Securities and Cash Flow Hedges</u>. Under the Basel III Proposal, unrealized gains and losses on banks' AFS securities are among the AOCI that must be recognized in the new CET1. The Agencies themselves acknowledge, and we concur, that fluctuations in the market values of debt securities that banks commonly hold could inject volatility on regulatory capital ratios. This is because if there is a change in the value of an AFS security (typically a daily occurrence) a bank must immediately adjust its regulatory capital.

Many CBA member banks hold debt securities that have significant unrealized gains because rates have steadily fallen in recent years. History and the nature of the economic cycle tell us that interest rates will eventually rise again, which means that banking organizations must anticipate the impact of a turnaround in rates on their regulatory capital. If interest rates rise the value of these securities will fall, triggering higher allocations of capital just as the economy is improving. But since capital is difficult to raise for smaller banks, many will have no choice but to shrink their balance sheets, which will have the broader effect of reducing the availability of credit in the market and dampening economic growth.

We are also concerned about the effect of the Proposal on smaller banks' regulatory lending limits, which are based on bank capital ratios. Significant swings in capital could cause disruptions in important customer relationships and lead to loss of business to larger banks. For these reasons we believe that unrealized gains and losses that predominantly result from changes in interest rates should not flow to regulatory capital.

The Basel III Proposal would also require banking organizations to deduct any unrealized gain and add any unrealized loss on cash flow hedges included in AOCI to CET1. We oppose this Proposal on some of the same grounds as articulated with regards to AFS securities. Cash flow hedges present little or no economic risk to a bank; indeed they are intended to mitigate risks. The deduction would discourage banks' use of a proven and reliable tool to manage interest rate risk in a safe and sound manner. Therefore, the Agencies should eliminate this proposed deduction.

<u>Phase-Out of Trust Preferred Securities as Capital Instruments</u>. The Basel III Proposal requires the phased elimination of trust preferred securities and other instruments for purposes of capital for bank holding companies with between $500 million and $15 billion in total consolidated assets. Only 90% of the carrying value of such instruments may be included in 2013, and then through January 1, 2022 the includable amount will be reduced by 10% each year until totally eliminated. This represents a departure from the Collins Amendment to the Dodd-Frank Act, through which Congress determined to remove from the exclusion institutions with less than $15 billion in assets. We believe that the Agencies do not have the regulatory authority to contradict federal legislation by applying the phase out to smaller banks as proposed. Therefore, this portion of the Basel III proposal should be withdrawn.

<u>Capital Buffer</u> The Basel III Proposal imposes a new requirement on banks to maintain a capital conservation buffer that consists of additional CET1 capital in an amount above 2.5% of total risk-weighted assets, beyond the minimum CET1 capital, Tier 1, and total capital risk-based capital ratios. If the buffer falls below this threshold, the banking organization would be restricted in the amount of capital distributions and discretionary bonus payments to executive officers that can be made. The Proposal applies in the face of existing regulatory restrictions on the payment of dividends and excessive executive compensation that provide adequate safeguards against the making of such payments in inappropriate circumstances. On this basis we believe that the buffer is excessive and would cause banks to shrink their lending portfolios.

Banks' Allowance for Loan and Lease Losses ("ALLL") already serves as a buffer against potential loan losses. We believe existing rules and regulations are sufficient to enable federal banking regulators to address the circumstances under which the payment of dividends and executive compensation may not be appropriate. The Agencies ought to consider the necessity of providing an exception for capital distributions paid by Subchapter S institutions which, in essence, pay income taxes indirectly through the institutions' shareholders.

**Specific Comments (Standardized Approach Proposal)**

Risk-Weighting of "High Volatility Commercial Real Estate" ("HVCRE") Loans. Under the Standardized Approach Proposal acquisition, development, and construction loans where the borrower does not inject cash or unencumbered readily marketable collateral of at least 15% of the appraised "as completed" value of the project will be assigned a risk weight of 150%. We ask the Agencies to reconsider the efficacy of applying the capital charge based primarily on a single factor instead of applying a more flexible approach that accounts for the presence of other forms of collateral and other risk-mitigating factors and techniques employed by experienced commercial real estate lenders. We are concerned that this portion of the Proposal may unduly restrict the flexibility that community banks need when conducting commercial real estate lending, which for many is a core business.

Increasing Risk Weights for Delinquent Loans. The Standardized Approach Proposal requires banking organizations to apply a 150% risk-weighting to assets that are 90 days or more past due or that are on nonaccrual status to the extent that those assets are not secured or guaranteed in accordance with the requirements of the Standardized Approach Proposal. We believe this change is unnecessary as the risks inherent in past due assets are already addressed under applicable accounting rules on loan loss provisions. Banks' ALLL already takes into account credit scores, delinquencies, LTVs, and local market conditions. The additional risk weights are redundant and will only drive up the cost of credit and make banks overly conservative. This change would also motivate banks to remove delinquent loans off their books more quickly rather than work constructively with borrowers. Experienced bankers, under the careful supervision of their prudential regulators, should have the flexibility to work through past due loans using their judgment rather than be subject to punitive risk weights based on a stepwise delinquency schedule.

Risk Weighted Treatment of Mortgage Lending. Under the Standardized Approach Proposal, residential mortgages are divided into two categories for purposes of risk-weighting. Category 1 mortgages are assigned lower risk weights and consist of traditional mortgages with maturities of no longer than 30 years, feature regular periodic payments and interest rates that do not exceed specified limits, and comply with specified underwriting standards. As proposed, the definition of Category 1 mortgages is similar in concept to, but not coordinated with, the proposed definitions of "qualified mortgages" and "qualified residential mortgages" under Title XIV of the Dodd-Frank Act.

Category 2 mortgages, that is, mortgages that do not meet the Category 1 criteria, would be subject to at least twice the risk weights that are applicable under the existing capital rules. If an outstanding Category 1 loan is 90 days or more past due or is on non-accrual status, it must be re-assigned to Category 2. The Proposal also eliminates some of the benefits of private mortgage insurance ("PMI") by not allowing a bank to incorporate the availability of PMI for the purpose of calculating the LTV ratio.

The effect of the changes would be that all but the most conservatively underwritten mortgage loans will be subject to higher risk weights. By stipulating the specific characteristics of loan activities that would be favored or penalized the Proposal (not unlike the proposed qualified mortgage regulation) attempts to pick market winners and losers by regulatory fiat. (For example, mortgage loans modified pursuant to the federal "HAMP" criteria, for example, receive the most favorable treatment regardless of actual risks). A variance from a specified Category 1 standard could invoke unfavorable Category 2 treatment despite the loan's overall risk profile. The main thrust of this part of the Proposal is that banking organizations will have less flexibility to develop products that respond to the needs of their customers, and instead would be driven by one-size-fits all capital requirements that are not necessarily sensitive to the market or to actual risks. By impairing banks' ability to respond effectively to the demands of their local markets, this framework would also constrain economic activity and earnings.

CBA and its members are also very concerned that the mortgage risk weighting portion of the Proposal would require banking organizations to adopt and manage sophisticated systems to comply with the complex rules. It creates a compliance regime that is heavily dependent on the collection of data and stratification of assets. These new standards, as proposed, would apply both to new and existing mortgages that were underwritten and booked pursuant to existing capital standards. To comply, banking organizations would have to retroactively review loan files to determine the appropriate risk weights to apply.

The broader effect of this part of the Proposal may be to cast doubts about the ability of some community banks to remain competitive in the important residential mortgage line of business. With little doubt, implementing these new capital changes will cause all banks to curtail their mortgage lending activities except possibly for the offering of plain vanilla mortgages that meet the needs of a certain class of consumers. As the Agencies know, there are hosts of consumers who are self-employed or otherwise do not have regular W-2 income, or anyone who wishes to acquire property that does not precisely conform to Category 1 criteria, who will have even greater difficulty obtaining reasonably-priced residential mortgage loans—at least not from regulated banking organizations.

CBA recommends that this portion of the Proposal be withdrawn in light of the responses already taken so far to ameliorate residential mortgage lending risks by Congress under the Dodd-Frank Act, by banks in tightening credit underwriting standards and procedures, and by the Agencies through heightened supervision. To the extent that the Proposal will be adopted, the Agencies should consider how to coordinate the treatment of Category 1 loans and Dodd-Frank

Act qualified mortgage loans in the interest of improving efficiency and reducing compliance burdens. We ask that proposed changes to risk weighting be applied prospectively only to new loans after the effective date. We also ask that risk weighting should recognize private mortgage insurance which, when properly written, gives lenders flexibility when offering residential mortgage credit that does not precisely meet Category I criteria, as proposed.

Mortgage Servicing Assets. Under the Standardized Approach Proposal, banking organizations are required to deduct mortgage servicing assets (net of deferred tax liabilities) that exceed 10 or 15 percent of their CET1 capital (depending on whether deferred tax assets and unconsolidated financial entity investments are considered). In addition, the amount that is below the 10% threshold will receive a 100% risk weight (and eventually 250% beginning in 2018). Presumably this new standard applies in conjunction with the current rule that imposes a 10% deduction on the fair market value of readily marketable mortgage servicing assets that are included in regulatory capital.

Here too we ask what is the compelling rationale for the deduction that justifies potentially compelling some banks to exit the mortgage servicing business, which in turn interferes with their important customer relationships and reduces earnings? If the Proposal is to be adopted, we ask that this particular provision is withdrawn or, if not withdrawn, that the Agencies consider allowing higher percentages of servicing assets to be included in CET1 capital and/or that existing mortgage servicing assets are grandfathered under the existing rules

Credit Enhancing Representations. Under the Standardized Approach Proposal if a banking organization provides a credit enhancing representation or warranty on assets it sold or otherwise transferred to third parties, it would be required to treat such arrangement as an off-balance sheet guarantee and apply a 100% credit conversion factor "(CCF") to the exposure amount. This would include sale agreements that include representations and warranties pertaining to early default, premium refunds, and instances of fraud, misrepresentation or incomplete documentation.

We wonder whether the CCF is justified, and we urge the Agencies to investigate the actual losses that banking organizations have experienced arising from short-term representations and warranties associated with the vast majority of "conforming" loans that are sold. Even if it is determined that credit enhancements led to the return of some assets or liability and that banks subsequently experienced losses, the Agencies should still consider whether existing accounting and other rules and the regulatory and prudential measures already undertaken after the financial crisis adequately address these shortcomings without the necessity of imposing further capital measures. Absent clear and convincing evidence of such need, we recommend that the Agencies withdraw this portion of the Proposal.

If this proposal will be adopted, we ask for further clarification about the type of representations that are covered and the length of time that the CCF is required to be applied. Some "enhancements" are for the life of the loan (such as representations for fraud) and others only for the duration of the current 120 day safe harbor. Any appropriate charge should be calculated based on the extent of the seller's actual liability, which may or may not be the principal amount of the loan. In the case of early default, for example, the liability is the amount of the seller's premium and processing fee.

Deferred Tax Assets ("DTAs"). The Standardized Approach Proposal would deduct certain DTAs from capital in accordance with complex rules. The benefits of excluding these valuable assets that help sustain banking organizations' financial health and viability has not been substantiated, at least not in light of the costs of the deductions to banking organizations. Current accounting rules address the comprehensive characterization of banks' tax planning posture, and we believe that elimination of net covered DTAs in capital would lead to less transparent financial statements for financial institutions. At any rate, the complex calculations necessitated by this proposal create yet another burden on banking organizations where the benefits have not been demonstrated.

Small Savings and Loan Holding Companies. For no articulated principled reason, neither of the Proposals exempts small savings and loan holding companies. Section 171 of the Dodd-Frank Act codifies the Federal Reserve Board's policy statement excluding certain non-complex bank holding companies with less than $500 million in consolidated assets from the capital rules. There does not appear to be an intent by Congress to make a principled distinction between small bank holding companies and small savings and loan holding companies ("SLHCs") grounded in differential safety and soundness concerns. Yet the Proposals, in keeping with Section 171, would not extend the exemption to small SLHCs from the Proposals.

We see no basis for the distinction and recommend that small SLHCs are treated equally. This apparent omission would immediately create competitive disadvantages in the marketplace among otherwise similarly situated companies. Moreover, the Proposal would force many small SLHCs to develop anew costly compliance infrastructures to which they are not accustomed. Some could avoid the standards by converting to commercial bank charters, but this would be an unintended consequence rather than an intentional policy directive or market-driven outcome. Therefore we ask that whatever is finally proposed, small SLHCs and small bank holding companies are treated equally.

**Conclusion**

These complex Proposals that will raise certain capital ratios and refine the risk weightings of numerous classes of bank assets could have profound effects on the U.S. banking industry and would be extremely burdensome to apply, particularly for smaller banking organizations. It would be impossible for the industry and even bank regulators to foresee and understand the full impact that these changes. We understand and appreciate that a great deal of work and thought went into preparing the Proposals. We concur with the overarching purpose of the Proposals to ensure that banking organizations have adequate capital to absorb losses. CBA and its members wish to work with the Agencies to ensure that appropriate standards are in place that would help ensure that the industry thrives. We appreciate this opportunity to offer these comments.

Sincerely,

Leland Chan
General Counsel