American Bankers Association

Building Success. Together.

October 25, 2012

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Regulatory Capital Rules:

Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (OCC Docket ID OCC-2012-0008, RIN 1557- AD 46; FRB Docket No. R- 1442, RIN 7100 – AD 87; FDIC RIN 3064-AD95);
Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements (OCC Docket ID OCC-2012-0009, RIN 1557 – AD 46; FRB Docket No. R- 1442, RIN 7100 – AD 87; FDIC RIN 3064-AD96); and
Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule (OCC Docket ID OCC-2012-0010, RIN 1557 – AD 46; FRB Docket No. R- 1442, RIN 7100 – AD 87; FDIC RIN 3064-AD97)

Dear Sir or Madam:

The American Bankers Association (ABA) on behalf of its many mutually chartered members is pleased to submit comments on the Notice of Proposed Rulemakings (Proposed Rules) published by the Federal Reserve Board, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency (collectively the Agencies) to implement Basel III in the United States on the particular impact the Proposed Rules have on the mutual charter.

There is no doubt that mutual institutions were not contemplated by the Proposed Rules. Mutual institutions have no stock; their growth is by retained earnings exclusively, while other banks have additional sources of capital. There is no capital market for a mutual institution.[1] Mutual institutions are conservatively run by necessity and their resilience during the crisis demonstrates the wisdom of that approach (only 17 failed during the 2007 to August 2012 time period). Mutually chartered institutions are operated with an eye to the long term. They contribute to their communities because as their communities grow, they grow.

The Proposed Rules substantially and disproportionally impact mutual charters because, if adopted as proposed, they introduce a level of volatility that is contrary to a business plan that focuses on the long term. Mutual institutions plan their growth and acquisitions carefully because they cannot respond quickly – retained earnings accrue over time. Our Mutual Institutions Council, a group of 100+ mutual institutions, including both federal and state charters, has reviewed the Proposed Rules, giving particular consideration to how they will affect their operations. This letter reflects the thoughts of the Council and it is offered in addition and to complement the views on the Proposed Rules submitted by ABA jointly with other financial trade associations ("Joint Trade Association Letter").

I. Introduction

A. Mutually Chartered Institutions

The mutual industry is and has been a vibrant participant in the financial development and growth of this nation. There are 600+ mutually chartered institutions with $253 Billion in assets ranging from 197 with assets under $100 Million to 46 with assets of more than $1 Billion. Some mutuals date back to just after the U.S. Civil War and have withstood depressions, wars, and the ebbs and flows of the economic life of this country. Often, the mutual is one of, if not the only, hometown bank in a community. Because of the long-term focus without the need for quarterly shareholder performance, mutuals provide services that some others may not because they do not meet sufficiently high profitability metrics. Their participation in the life of their communities is second to none. They are the sponsor of the charities, fireworks, economic development, financial education and many of the activities and functions that make communities vibrant and family and child focused. They are and have been the anchor of financial stability in many economic storms.

B. The Impact of Basel III on Mutual Institutions

As noted in almost every comment letter to date on the Proposed Rules, implementation of Basel III fundamentally changes every aspect of regulatory capital -- narrowing what counts as capital, changing risk weight calculations and establishing new required levels of capital. The impact is surprising to many that have been and remain well-capitalized through the most recent economic difficulties. Few, if any, mutually chartered institutions trust today's point-in-time calculations.

[1] While Mutual Holding Companies ("MHCs") may offer minority shares, most remaining MHCs are no stock MHCs by business model or due to the restrictions of Federal Reserve Regulation MM.

Simply put, the repercussions of not being well capitalized are severe. A bank's capital position may flip in an instant depending on the valuation date. No one is confident that they will continue to meet the well-capitalized standards between mark-to-market requirements, new mortgage risk weights, and other proposed changes.

The question that has to be answered for community institutions and mutually chartered banks alike is whether communities will benefit from the substitution of mechanical calculations that fluctuate daily with a regime that is focused on quality underwriting and quality supervision. The Proposed Rules were never designed for the mutually chartered bank. It is inconceivable that the Agencies would voluntarily and without the benefit of rigorous research and study, propose rules with such far-reaching consequences. For these reasons, and the specific comments that follow, that the ABA's Mutual Institutions Council, respectively urges the Agencies to reconsider and remove the counterproductive proposals that defeat, not enhance, the safety and soundness of community banks and mutual institutions in particular.

C. Overall Impact

Mutual institutions, like many of their community bank brethren, are 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, the only rational response will be to hold more capital than might ultimately be required. As a result, even though the existing well-capitalized standard is 10% total capital to risk-weighted assets, mutual institutions often manage themselves well above the existing capital standards to provide a regulatory buffer because of their reliance on retained earnings.

If a bank falls short of its effective minimum it generally has three options. Large banks with access to national markets can issue new capital instruments to meet the regulatory demands. Mutual institutions, because they are dependent on retained earnings, lack access to national credit markets, are often unable to raise new capital – pledged deposits are cumbersome and rarely, if ever used, and mutual capital certificates, if ever issued, are no longer specifically authorized as they were under obsolete regulation 12 U.S.C. 563.74 (1994). Using the mutual holding company structure, mutual institutions were able access the national credit markets through the Trust Preferred market. However, that option is no longer available. What are left are retained earnings, a challenging option given higher operating expenses resulting from the Dodd-Frank Act and ongoing national economic stress.

For a mutual that cannot boost earnings, there is no choice but to shrink the bank. To increase the capital-to-assets ratio to the level demanded by the proposals, many banks will be forced to freeze, or even reduce, their lending. The vital role mutual institutions play in their communities would be hampered if loans become more expensive and more difficult to obtain. And yet it would not result in safer and sounder operation, and would fail to benefit the nation's economic recovery.

D. The ABA's Position on the Recent Basel III Proposals

ABA has consistently voiced strong support for ongoing regulatory reform efforts that aim to make financial systems safer and more robust. This support includes improving the quality of capital in banks, which will reinforce the ability of the banking industry to serve its customers and promote economic growth. The Basel III proposals go beyond that and would actually weaken the banking industry, make it harder to serve customers, and inhibit economic recovery. To ensure the proposed capital standards strengthen and stabilize the banking industry, we believe that:

- Substantial changes need to be made to the general Basel III proposal to make it workable for mutually chartered institutions.

- The Standardized Approach NPR needs to be withdrawn and studied to not compromise the very structure of our broad and diverse banking industry.

II. Specific Comments on the General Basel III Proposal

A. Unrealized Gains and Losses on Available for Sale Securities

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.

Mutual institutions could execute three strategies to address the majority of the capital volatility problem; however, <u>none of them are advisable</u>.

First, an investment-eligible mutual institution could sell long term securities and buy short-term securities. By shortening the maturities of their assets, the mutual would be limiting marked-to-market volatility. However, it is the core tenet of interest rate risk management to match assets to liabilities. If a bank has long term liabilities and is attempting to limit its capital volatility by shortening the duration of its assets, the resulting shift in the duration within the investment portfolio will shift the bank's interest rate risk position from properly matched to being unmatched. Such an imbalanced position is not prudent risk management.

Large sophisticated banks may be able to offset the interest rate risk inherent in an unmatched balance sheet by using derivatives. While this is not an ideal solution for even the most sophisticated institutions, **interest rate derivatives are not a cost effective option for most institutions including mutual institutions**. The vast majority of mutual and community banks have little or no prior experience with derivatives. For these institutions, entering into the derivatives market could exacerbate the risk issues. Moreover, the higher costs related to entering into derivative contracts, along with the lower-yielding short-term securities mutual institutions would be pushed to hold, would impact earnings making it more difficult for some banks to meet the Basel standards. In short, derivatives are not the answer for mutual institutions.

Second, a mutual could move away from liquid investment securities to less liquid alternatives that do not have unrealized gains and losses. Unrealized gains and losses occur when a security is being held in the available for sale portfolio. To avoid the temporary gains and losses, the mutual could shift securities out of the available for sale portfolio into the "held to maturity" portfolio or shift from securities to loans. Both of these alternatives could significantly diminish the institution's liquidity position. Securities that are in "held to maturity" may not be sold by the bank without significant accounting repercussions and loans are generally not marketable. As a result, a mutual that shifts to held to maturity securities or loans reduces the number of highly liquid assets it has on hand in case of a liquidity event. The unintended consequence of allowing unrealized gains and losses to flow through capital is the undermining of prudent liquidity risk management.

And finally, a mutual could simply hold more capital or shrink. Yet its competitors, such as credit unions (also nonstock entities) that are already tax-advantaged are now capital-advantaged because they do not need to hold more capital. As noted previously, holding more capital lowers the lending in a community and shrinkage lowers loans-to-one-borrower limits and the ability to participate in the life of the community. It is important to recognize that impacting one part of the balance sheet will have unintended consequences that are difficult to manage in other areas of a mutual's operations. Safety and soundness requires balancing prudent operations in all of the bank's activities.

B. Pension Related Actuarial Unrealized Gains and Losses Should Also Be Excluded from Capital

Another example of the distortions created by removing the AOCI filter pertains to obligations under defined benefit pension plans. Pension obligation AOCI represents the difference between pension assumptions and actual experiences during a given year. Pension AOCI is predominantly influenced by the applied discount rate assumptions used to determine the value of the plan obligation. The discount rate is tied to prevailing interest rates at one point in time each year – it could be a good day for the market or a terrible day, but that one day sets the rate. And while market returns on the underlying assets of the plan and discount rates may fluctuate year to year, the underlying liability is typically longer term-- in some cases 15 to 20 years. This can lead to significant fluctuations in unrealized gains and losses. Removing the AOCI filter on pension liabilities could lead to material swings in capital which may be very different by the time the liability is paid and could lead some institutions to wind down their pension plans.

For mutual institutions, this is a crucial issue. Because mutual institutions do not have stock, many offer their employees defined benefit plans. This allows them to compete with their stock brethren for quality hires and to keep those quality staff members from being lured away. Eliminating or exacerbating the balance sheet impact through the removal of the AOCI filter will handicap mutual institutions in their ability to offer competitive retirement options and limit the pool of qualified employees who will provide that long term and human touch for their customers and communities. At a minimum, as noted in the Joint Trade Association Letter, the Agencies should exclude the effects of future compensation increases from the capital calculation since it is highly unlikely that such increases would be realized in the event the institution was distressed or placed in receivership.

C. Trust Preferred Securities (TruPS)

The General Basel III proposal takes a more conservative approach to TruPS and other non-qualifying capital instruments than the Dodd-Frank Act requires of depository institution holding companies between $500 million and $15 billion in total consolidated assets. In the Collins Amendment, Congress explicitly grandfathered the Tier 1 capital status of debt or equity instruments (such as TruPS) issued before May 19, 2010, by depository institution holding companies between $500 million and $15 billion as of December 31, 2009. Although these institutions understood that no new TruPS instruments could be issued, grandfathering allowed small institutions to replace TruPS as they matured, resulting in an orderly replacement process. Since enactment of the Dodd-Frank Act, smaller banking organizations have relied on the statutory proviso that such instruments are grandfathered. Yet, the Proposed Rules fail to recognize the grandfathering and require a definite phase out. **Mutual institutions do not have many, if any, options for replacing TruPS.** For this reason, and to be consistent with Dodd-Frank Act, the Agencies should recognize the permanent grandfathering of Section 171(b)(4)(C) for institutions between $500 million and $15 billion.

D. Mortgage Servicing Assets

Under the General Basel III proposal, mortgage servicing assets ("**MSAs**") includable in regulatory capital would decrease from the current 100 percent of Tier 1 to 10 percent of CET1, which would be a significant drop for those banking organizations with retail mortgage servicing operations.[2] The Mutual Council and all of ABA are concerned that, 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 or hold in portfolio.

Mutuals like their community banker brethren 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 and inevitably

[2] This is before the overall 15 percent limitation on the combined balance of includable MSAs, DTAs and investments in the common stock of financial institutions.

discourage and penalize neighborly service and good banking care of customers and communities. Deducting mortgage servicing assets doesn't just lower a bank's capital ratios, it undercuts the basic philosophy of mutual operations. It is unsound for the banking agencies to discourage long term relationships: mortgage servicing assets should not be deducted at any threshold.

III. Specific Comments on the Standardize Approach NPR

A. Mortgage Treatment

The Standardized Approach NPR assigns different risk weights to residential mortgage exposures based on (i) whether the mortgage is a "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 1 mortgages vary from 35 percent to 100 percent, with higher risk weights associated with higher LTV ratios. Risk weights for category 2 mortgages range from 100 percent to 200 percent, with higher risk weights likewise depending on higher LTV ratios. However, the proposed changes 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. The flaws of this type of approach are explained in great detail in the Joint Trade Associations Letter. However, the Mutual Council would like to highlight a few key points.

i. The Proposed Mortgage Treatment is Misguided and should be Withdrawn

The preamble to the Standardized Approach NPR asserts that category 2 mortgages are subject to higher risk weights because they "generally are of higher risk," whereas category 1 mortgages "reflect those underwriting and product features that have demonstrated a lower risk of default both through supervisory experience and observations from the recent foreclosure crisis." Despite these assertions, the proposed rule fails to present any empirical data or other evidence to support the assertion that category 2 mortgages present higher risks that might not have been addressed, and are not being addressed, by widespread changes to underwriting standards many of which are or will be mandated by provisions of the Dodd-Frank Act and their implementing regulations, such as those relating to "qualified mortgages" and "qualified residential mortgages." The Mutual Council requests the Agencies withdraw the proposed mortgage treatment until they have considered how the proposal interacts with other aspects of regulatory reform.

ii. Grandfather Existing Mortgages

Many mutual institutions hold significant numbers of residential mortgages in portfolio; however, the data fields required were not fields routinely captured in electronic files when the loans were made. The data points exist; however, they exist in the loan files themselves. The Proposed Rules would require every mutual institution to go back to paper files and find additional data to categorize the loans. For this reason, ABA encourages any categorization requirement to apply on a going forward basis rather than require the historic “mining” of portfolio loans. **The Agencies should grandfather existing mortgages at a minimum.**

There is no reason to turn an excellent credit into a higher risk asset by mere fiat. Existing mortgages were priced and placed on the books based on the best information and knowledge of costs and requirements at the time. The Proposed Rules upend that pricing with substantially different requirements. Moreover, the Proposed Rules do not reflect what may happen with other rulemakings including Qualified Mortgage, GSE reform or other risk retention efforts. Mutual institutions need certainty in the requirements applied to existing mortgages. It is consistent with rulemaking in general and certainly justified by the practical hurdles retroactive application will cause.

iii. Junior Liens Should Not Taint the First

Under the proposal many standard, prudently underwritten HELOCs would be deemed category 2 loans due to characteristics such as floating interest rates, interest-only periods and balloon maturities. This treatment is unwarranted given that banks generally offer HELOCs to higher-quality borrowers and HELOCs performed consistently with prime mortgage exposures even through the crisis. Further, 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.

Mutuals are relationship bankers. For mutual institutions that have seasoned loans on their books, it is inconceivable that the granting of a second on a seasoned first to fund the kitchen renovation or the college tuition bill somehow taints the entire relationship. The thought of requiring a longstanding customer to go through the many steps of refinancing his or her first in order to update the kitchen is unworkable – the customer will go across the street to another institution. The banker who has the seasoned paying loan, should not be discouraged from maintaining that relationship. Yet, the Proposed Rules substitute mechanical buckets for underwriting, taint the entire relationship, or result in less security for the loan.

B. Equity Treatment

Under the proposed Simple Risk-Weight Approach, the risk-weighted asset amount for each equity exposure would be the carrying value of the equity exposure multiplied by risk weights ranging from zero percent to 600 percent. In a significant departure from the existing general risk-based capital rules, the Standardized Approach NPR would assign a 300 percent—rather than a 100 percent —risk weight to publicly traded equity exposures.

This proposed increase in the risk weight for publicly traded equity exposures would disproportionately impact certain state-chartered mutual savings banks and other institutions. In certain cases mutual banks are permitted to hold a greater percentage of equity exposures than other types of depository institutions. The proposed increase from 100 to 300 percent would have an enormous impact on such mutual banks because equity exposures account for nearly 25 percent of some mutual banks' assets. As such, the Mutual Council requests the banking agencies maintain the current 100 percent risk weight for publicly traded equity exposures.

IV. Conclusion

As Dov Seidman states in his book, "HOW – Why HOW We Do Anything Means Everything," rules are necessary, but "[r]ules respond to behavior; they don't lead it."[3] Capital is the currency of growth and recovery and must be focused on the future, not the past. The Proposed Rules need to promote the future and not hamstring the economic engines that make that future a reality. Mutuals have experienced and survived much and they deserve a fair chance to continue to promote their future and the future of their communities. ABA appreciates the ability to express the particular concerns of mutually chartered banks and the communities they serve. If you have any questions on the issues raised or wish to discuss any of the items further, please contact Hugh Carney at 202- 663-5324 (hcarney@aba.com), or either of the undersigned at 202-663-5434 (dcausey@aba.com) or 202-663-5588 (rdavis@aba.com).

Sincerely,

C. Dawn Causey
General Counsel

Robert R. Davis
EVP, Mortgage Markets, Finance Management & Public Policy

[3] Seidman, Dov, "HOW – Why HOW We Do Anything Means Everything," p. 86 (John Wiley & Sons, Inc. 2007).