MBCA

MID-SIZE BANK COALITION OF AMERICA

ASSOCIATED BANK
BANCO POPULAR NORTH AMERICA
BANK OF HAWAII
BOK FINANCIAL
CITY NATIONAL BANK
COMMERCE BANCSHARES, INC.
EAST WEST BANK
FIRSTBANK HOLDING COMPANY
FIRST HAWAIIAN BANK
FIRST HORIZON NATIONAL CORPORATION
FIRSTMERIT CORPORATION
FROST NATIONAL BANK
FULTON FINANCIAL CORPORATION
HANCOCK BANK
IBERIA BANK
MB FINANCIAL
OLD NATIONAL
ONE WEST BANK
PEOPLE'S UNITED BANK
RAYMOND JAMES BANK
SCOTTRADE BANK
SILICON VALLEY BANK
SUSQUEHANNA BANK
TCF FINANCIAL CORPORATION
THE PRIVATE BANK
TRUSTMARK CORPORATION
UMB FINANCIAL CORPORATION
UMPQUA BANK
VALLEY NATIONAL BANK
WEBSTER BANK

October 22, 2012

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, DC 20219
Docket IDs OCC–2012–0008, –009

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket Nos. R–1430, R–1442; RIN No. 7100–AD87

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
FDIC RIN 3064–AD95

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

Ladies and Gentlemen:

On behalf of the Midsize Bank Coalition of America ("MBCA"), I am writing to provide the MBCA's comments on the above-referenced joint notices of proposed rulemaking published by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, "the Agencies") in the Federal Register on August 30, 2012.[1]

[1] *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 FR 52791 (Aug. 30, 2012); *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets: Market Discipline and Disclosure Requirements*, 77 FR 52887 (Aug. 30, 2012).

The MBCA is a non-partisan financial and economic policy organization comprising the CEOs of mid-size banks doing business in the United States. Founded in 2010, the MBCA, now with 31 members, was formed for the purpose of providing the perspectives of mid-size banks on financial regulatory reform to regulators and legislators. As a group, the MBCA banks do business through more than 3,800 branches in 41 states, Washington D.C. and three U.S. territories. The MBCA's members' combined assets exceed $450 billion (ranging in size from $7 billion to $30 billion) and, together, its members employ approximately 77,000 people. Member institutions hold nearly $336 billion in deposits and total loans of more than $260 billion.

The MBCA appreciates the Agencies' efforts to implement the risk-based and leverage capital requirements agreed to by the Basel Committee on Banking Supervision in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems," as well as the capital requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2] We understand that the Agencies devoted extensive time and energy to drafting the proposal rules. However, consistent with FDIC Director Thomas M. Hoenig's request,[3] we respectfully ask you to step back, reassess the overall intent and the impact the proposed rules will have on the financial system, and delay rolling out any new rules.

> In his recent address to the American Banker Regulatory Symposium, Mr. Hoenig summarizes a good capital rule as follows:
>
> Experience suggests that to be useful, a capital rule must be simple, understandable and enforceable. It should reflect the firm's ability to absorb loss in good times *and* in crisis. It should be one that the public and shareholders can understand, that directors can monitor, that management cannot easily game, and that bank supervisor can enforce.

The current proposed rules, which seek to control nearly every aspect of a bank's operations, rely on highly complex modeling tools and on central planners making determinations of risk rather than the markets. As a result, the proposed rules would change risk weights from "five to thousands."[4] Their adoption as proposed would create adverse incentives for banks making asset choices, rather than choices that ensure banks' communities and borrowers are well served. Bankers react to incentives that are placed before them. We believe the proposed rules, if not substantially altered, will potentially skew those incentives and misalign risk and returns. The result will be the loss of some products and services.

At a minimum, the MBCA believes that certain aspects of the proposed rules should be revised to take account of the implementation burdens on banks, their rules' competitive impact on mid-size banks, and the likely consequences of the rules for the availability of credit and

---

2 Pub. L. No. 111-203, 124 Stat. 1376-2223 (2010).

3 Thomas M. Hoenig, Director, Federal Deposit Insurance Corporation, Address to The American Banker Regulatory Symposium: Back to Basics: A Better Alternative to Basel Capital Rules (Sept. 14, 2012), *available at* http://fdic.gov/news/news/speeches/chairman/spsep1412_2.html.

4 *Id.*

national financial stability. To streamline our comments, below we address those areas in which we believe revision is most critical.

I. Other Comprehensive Income on Available-for-Sale Securities

The proposed rules would require banks to include unrealized gains and losses on available-for-sale ("AFS") securities currently recorded in accumulated other comprehensive income ("AOCI") as part of common equity tier 1 capital. We believe this approach is misguided for several reasons discussed below.

A. Inconsistent with Sound Asset/Liability Management Practices

AFS investments are critical to a bank's Asset/Liability management practices. In our view, the proposed treatment of these investments would create a disincentive for banks to engage in sound risk management practices. Banks use AFS investments to help stabilize interest income over the business cycle while providing a warehouse of liquidity that can be accessed during periods of high loan demand and/or declining deposit balances. AFS investments serve as a source of liquidity that helps manage the interest rate risk exposure created by core banking activities. Most of a bank's longer-term securities are funded with core deposits that the bank believes have similar or longer durations. If rates rise, the decrease in the value of AFS securities would be offset by an increase in the value of the deposits used to fund the securities. Generally, smaller banks try to minimize taking credit risk in the portfolio by maintaining significant investments in U.S. government and agency debt obligations, U.S. GSE debt obligations, and municipal bonds. This is a sound interest rate risk management practice.

Banks perform interest rate risk management analyses on a regular basis and make hedging decisions based on the performance of the entire balance sheet as rates change. The proposed rules' treatment of AOCI on AFS securities, however, looks at only one piece of one side of the balance sheet. As the AOCI on a bank's AFS investments would be included in regulatory capital under the proposed rules, interest rate changes could have significant implications for regulatory capital. The resulting fluctuations could influence a bank's on balance sheet hedging strategy – economically sound decisions could be compromised if management were forced to modify decisions it believed to be in the best interest of the bank in order to limit mark-to-market implications from one piece of its balance sheet.[5] This could create a capital constraint that may limit otherwise sound Asset/Liability management.

[5] For example, banks might respond by shortening the duration of their securities portfolios in an effort to reduce volatility. This would result in significantly reduced earnings and would be contrary to sound risk management practices regarding interest rate risk. In a broader sense, if most banks were to follow this path, lack of demand for longer term securities might push up longer rates, making mortgages and municipals, among other longer borrowings, more expensive. Banks might also choose to shorten the duration of liabilities in order to maintain an appropriate mismatch. Where a bank's funding is mostly long-term, non-contractual funding, this move would require adding more short-term wholesale funding – a move clearly at odds with the proposed liquidity standards (LCR and NSFR). Finally, a bank may elect to move some or most of its securities from AFS to Held-to-Maturity simply to avoid the proposed AFS-AOCI requirements. Not only would this result in much less flexibility, but it also may reduce liquidity.

B. Reduced Confidence from More Volatile Capital Measures

In addition to discouraging sound Asset/Liability management practices, the volatility in regulatory capital ratios that would result from the inclusion of AOCI on AFS securities in common equity tier 1 capital would reduce confidence in the capital measures themselves. Even a bank with very strong capital ratios comprised almost solely of common equity – such as one of the MBCA's member banks, which has a total risk-based capital of 16.6% – could be greatly affected if interest rates were to shift quickly. For example,

- A 2% shift up in rates would reduce the bank's regulatory capital by 240 bps as a result of unrealized securities losses.

- A 4% shift up in rates would reduce the bank's regulatory capital by 570 bps as a result of unrealized securities losses.

Such a shift in interest rates could even push ratios close to regulatory limits.

This volatility is exacerbated by the proposed "limited recognition" of deferred tax assets to 10% of common equity. Unrealized gains and losses, including in AOCI, are tax-adjusted such that deferred tax assets are created when unrealized losses exist, reducing the total net amount of unrealized losses. Today, these tax assets are not limited when calculating regulatory capital. If the tax asset is limited, as proposed, and the limit is exceeded, net unrealized losses will create even greater volatility in capital. We believe that the significant volatility created by this proposal and cap on deferred tax assets will result in less confidence in capital ratios as a barometer of adequacy and as a tool for determining a bank's cushion to contain losses. If the proposed rules are adopted as drafted, investors and others will be reluctant – if not unable –to rely on an institution's capital ratios unless the institution removes all or most ofithe AFS from its balance sheet.

C. Reduction in Lending Capacity in an Economic Recovery

Finally, the proposed rules' treatment of AOCI on AFS securities would decrease the ability of banks to extend credit, as regulatory capital may decrease substantially as interest rates rise. This structural limit on lending by itself will seriously impede a potential economic recovery. Indeed, the effect will be compounded because banks will need to hold additional capital above regulatory limits to protect against even the *potential* for volatility. Lost regulatory capital and lower lending capacity could even result in a declining rate environment, if credit spreads widen or securities lose value simply due to a lack of buyers. This would accelerate an economic downturn.

The MBCA recommends that the Agencies exclude from common equity tier 1 capital AOCI on certain AFS securities for which the gains and losses are primarily due to interest rate rather than credit and market risk changes (including U.S. government and agency debt obligations, U.S. GSE debt obligations, and municipal bonds) to preserve sound Asset/Liability Management practices and to reduce volatility in capital ratios.

II. Deferred Tax Assets

The MBCA believes the proposed rules' requirements regarding deductions of deferred tax assets ("DTAs") from common equity tier 1 capital fail to reflect practical realities in several key respects.[6]

The 10% and 15% limits on DTAs and the 250% risk weight imposed by the proposed rules are unduly punitive. U.S. generally accepted accounting principles ("GAAP") require that DTAs be reduced by a valuation allowance that is sufficient to reduce the DTAs to the amount that is more likely than not to be realized. Therefore, only DTAs that are more likely than not to be realized stay on the balance sheet of a U.S. banking organization. DTAs subject to the limits arise because taxable income computed under the tax laws is higher than income reported under GAAP. Such DTAs should not be viewed as indicators of future earnings problems that would result in depletion of capital – on the contrary, for MBCA members, DTAs are highly likely to yield tax benefits in the future.

Moreover, the 10% and 15% limits on DTAs would exacerbate the regulatory capital impact of the proposed requirement that AOCI on all AFS securities flow through to common equity tier 1 capital. As discussed above, under the proposed rules, unrealized losses on AFS securities would reduce common equity tier 1 capital. Unrealized losses create DTAs. If the amount of DTAs exceeding the 10% and 15% limits were deducted from common equity tier 1 capital, as proposed, AOCI on AFS securities could reduce common equity tier 1 capital twice: first, directly, and second, through the creation of DTAs exceeding the 10% and 15% limits. One MBCA member has calculated that a 400 basis-point rise in interest rates would further reduce its capital ratios by an entire percentage point because of the proposed limits on DTAs and, as a result, reduce its lending capacity by $1.1 billion. Furthermore, subjecting DTAs resulting from AOCI on AFS securities to the 10% and 15% limits is not consistent with prudent management of assets and liabilities because it fails to recognize that the market value of the bank's liabilities funding the AFS securities would rise at the same time as AOCI on such securities creates DTAs.

---

[6] Under the proposed rules, a banking organization would be required to deduct the amount of DTAs that arise from operating losses and tax credit carryforwards, net of any related valuation allowances and certain deferred tax liabilities ("DTLs"). In addition, DTAs arising from temporary differences that a banking organization could not realize through net operating loss carrybacks, net of any related valuation allowances and certain DTLs, would be subject to a 10% limit and a 15% limit. Specifically, if the amount of such DTAs exceeds 10% of a banking organization's common equity tier 1 capital, the banking organization would have to deduct the excess from its common equity tier 1 capital. Two other types of assets – mortgage servicing assets (net of associated DTLs) and significant investments in the capital of unconsolidated financial institutions in the form of common stock – would each be subject to such a 10% limit. If the aggregate amount of these three types of assets, after deductions required by the application of the 10% limit to each of them, exceeds 15% of a banking organization's common equity tier 1 capital, the banking organization would have to further deduct this excess from its common equity tier 1 capital. DTAs subject to the 10% and 15% limits, if not deducted from common equity tier 1 capital as a result of the limits, would be assigned a 250% risk weight.

The proposed rules also are problematic in that they would allow netting of DTAs against deferred tax liabilities ("DTLs") only for those that "relate to taxes levied by the same taxation authority and . . . are eligible for offsetting by that authority." Under U.S. GAAP, a company generally calculates its DTAs and DTLs relating to state income tax in the aggregate by applying a blended state tax rate. Accordingly, banks do not track DTAs and DTLs on a state-by-state basis for financial reporting purposes. Tracking DTAs and DTLs on a state-by-state basis for purposes of the regulatory capital rules would be extremely burdensome. Therefore, the MBCA believes that the regulatory capital rules should allow netting in the aggregate for DTLs and DTAs relating to state income tax in all U.S. states, consistent with U.S. GAAP.

The MBCA also believes the Agencies should clarify that banking organizations will not be required to compute DTAs and DTLs quarterly for regulatory capital purposes. Under U.S. GAAP, companies are required to compute DTAs and DTLs annually, not quarterly. The MBCA believes that quarterly computation of DTAs and DTLs would be unjustifiably burdensome for most banks, and that annual computation, as is consistent with U.S. GAAP, is appropriate.

III. Minority Interest

The proposed rules would limit the amount of minority interest in consolidated subsidiaries that could be included in the regulatory capital of the parent company. Specifically, if a consolidated subsidiary has regulatory capital in excess of the sum of its minimum capital requirement plus the required capital conservation buffer, the minority interest that contributes to the excess would not be includable in the parent company's regulatory capital.

This limitation should not apply to a holding company that conducts substantially all its business activities in its depository institution subsidiary and therefore has limited exposure to losses outside that subsidiary. Many banks find that subordinated debt, which is usually issued to investors unrelated to the parent holding company and thus "total capital minority interest" for purposes of the proposed rules, provides a cost-effective form of capital. Limiting the amount of bank-issued subordinated debt that could be included in the parent holding company's tier 2 capital would nevertheless create a significant disincentive for raising such capital. One MBCA member estimates that the proposed limitation would lead to the exclusion of 35% of its subordinated debt from the regulatory capital of its parent holding company. Furthermore, because the proposed limitation would require deductions from the parent holding company's regulatory capital as outside investments in the subsidiary bank increase the regulatory capital of the bank, it would appear that the holding company is being penalized for increased capital adequacy at the subsidiary bank.

IV. Mortgage Servicing Assets

Under the proposed rules, mortgage servicing assets would be subject to the same 10% and 15% limits as deferred tax assets. In addition, the amount not deducted from capital under the proposed rules would receive a 100% risk weight (and eventually a punitive 250% beginning 2018). A mortgage servicing asset is the right by a bank to service mortgage loans owned by others and in many cases represents servicing the loans originated by the servicing bank and sold to other third parties like Freddie Mac and Fannie Mae. The combination of excluding the assets that exceed the 10% and 15% limits with the 100% (an eventually 250%) risk weighting could severely impact some banks, perhaps even lowering capital levels below well capitalized status. As a result, banks would be inclined to sell mortgage loans on a servicing-released basis. This would prevent a bank that originates a mortgage loan from maintaining a long-term relationship with the borrower by continuing to service the loan after selling it. It would also deprive the bank of an important source of fee income.

Furthermore, the proposed limits would disproportionately affect banks with a sizable portfolio of mortgage servicing assets that have been retained or acquired in reliance on current regulatory capital rules. These new limits might ultimately lead to further consolidation in the mortgage servicing industry to very large non-bank servicers that are not subjected to the same rules and standards as regulated financial institutions. As a result, bank customers would be relegated to dealing relatively impersonally with a large non-bank entity rather than interacting with the local community bank that knows them well. In sum, the MBCA believes that mortgage servicing assets should not be subject to the 10% and 15% limits, and if any limits are put in place, existing mortgage servicing assets should be grandfathered.

V. Unused Lines of Credit with a Term Under One Year

The proposed rules would require a bank to apply a 20% credit conversion factor to "commitments with an original maturity of one year or less that are not unconditionally cancelable" by the bank. As a result, a bank would need to include 20% of the unused portion of a line of credit with a term under one year in its risk-weighted assets, if the line of credit is extended to a corporate borrower.

The MBCA does not believe that the proposed 20% credit conversion factor for the unused portion of a line of credit extended to small, middle-market, or trade finance companies, with a term under one year, is warranted. The majority of such lines of credit have covenants based on financial ratios, and any material increase in the credit risk of the borrower would likely trigger a violation of a financial covenant, which would prevent the borrower from drawing down the unused portion of the line of credit. According to an academic paper from the University of Chicago Graduate School of Business, in a sample of 11,758 bank lines of credit, 72% had covenants based on financial ratios. When a borrower violates a financial covenant, the bank reduces the total line of credit by about 25 % in the year after the violation, and the unused portion of the line of credit is reduced by almost 50% from the year before the violation to the year after the violation.[7] In addition, a violation of the covenant may trigger an entry to the Allowance for Loan and Lease Losses ("ALLL").

We note that several analyses of exposure at default of lines of credit extended to corporate borrowers, including a 2011 study by Moody's, overstate such exposure because they

[7] Amir Sufi, *Bank Lines of Credit in Corporate Finance: An Empirical Analysis*, 22-25 (Jun. 2006), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=723361.

exclude reductions in the drawn amount that occurred before default.[8] Reducing the line of credit and the drawn amount when the borrower's credit risk increases is an important risk-mitigation technique, and analyses that fail to recognize this exaggerate the credit risk associated with lines of credit.

Furthermore, most lines of credit extended to small and middle-market companies are guaranteed by their owners. There is less incentive for the borrower to draw down a line of credit so guaranteed when it is likely to default because such draw-downs would increase the personal liability of the business owner.

The MBCA believes that the proposed 20% credit conversion factor would result in further tightening of credit availability to small, middle-market, and trade finance companies. Given this capital requirement, even if banks were willing to make loan commitments with an original maturity of one year or less to small businesses, they would tend to make such loan commitments unconditionally cancellable, which is not common now. As a result, a small business would face the new risk of losing access to existing lines of credit when the economy shows signs of trouble and credit becomes tight, even where the financial condition of the small business itself does not warrant the cancellation of the loan commitments. This uncertainty over credit availability would make it harder for small business owners to plan, hire, and run their businesses. We urge the Agencies to maintain a 0% credit conversion factor for commitments with an original maturity of one year or less and an amount of $5 million or less that are not unconditionally cancelable.

VI. Treatment of Residential Mortgages

A. Risk-weighting of Residential Mortgages

The MBCA disagrees with the Category 1/Category 2 approach developed by the Agencies in the proposed rules. The proposed definition of Category 1 loans would exclude, among others, any loan that (i) results in an increase of the principal balance, (ii) allows the borrower to defer repayment of principal of the residential mortgage exposure, (iii) results in a balloon payment, or (iv) does not include documented, verified income as a feature of the underwriting process. As a result, the proposed rules give the lowest risk weight only to the most traditional mortgage products without regard to the true risk associated with the loan. The proposed rules would exclude prudently underwritten interest only (IO) loans, prudently underwritten low or no documentation loans, and most junior liens, regardless of the performance of those loans. The MBCA believes the categorical exclusion of certain types of loans without regard to the risk associated with the loan is ill-advised, and we discuss the problems associated with that approach using these three examples below.

An IO mortgage is not an inherently dangerous product; any mortgage underwritten properly is a sound asset. Conversely, any loan underwritten poorly regardless of amortizing

---

8 Janet Yinqing Zhao et al., *Usage and Exposures at Default of Corporate Credit Lines: An Empirical Study*, 8 (Dec. 2011). http://www.moodysanalytics.com/Insight/Quantitative-Research/Default-and-Recovery/Research-Papers.aspx.

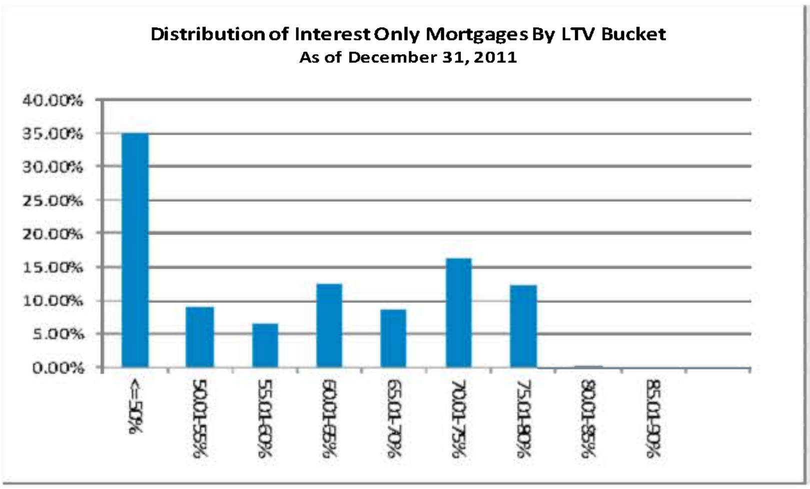
principal features is a risky asset. Many banks have originated IOs for decades and have had very low loss rates even during the recent recession. The IO mortgage transactions of our members historically have experienced very low delinquency rates both in number of accounts and in outstanding balances. One member, the experience of which is typical of MBCA members, noted that the vast majority of its mortgage transactions reside within high-quality credit buckets (LTV <= 60% and FICO scores above 710). Over the last three years, when real estate defaults have peaked nationwide, this member's IO mortgage loans have performed equal to or better than the amortizing portfolio. In other words, this member's IO residential mortgage portfolio is statistically no more risky than the amortizing residential mortgage portfolio. We emphasize the following three key points about the IO loan portfolio:

- Borrowers with low origination LTVs (60% or less) and high FICOs (700+) perform excellently regardless of whether it is an IO or an amortizing loan.

- Our members' stringent underwriting standards, which include qualifying an IO mortgage application based on a fully amortizing debt to income ratio, leads to superior performance of all IO mortgages, even those with LTVs in excess of 60%.

- The Agencies' exclusion of IO mortgages from Category 1 consideration would inadequately represent the true risk involved in a prudently underwritten IO loan. For example, IOs with an origination LTV of 60% have a 12.5 year principal reducing "head start" relative to an 80% LTV amortizing 30-year loan. Thus, there is no reason to penalize a preferable LTV IO mortgage relative to a standard amortizing loan. Labeling an 80% LTV amortizing loan less risky than a 60% IO mortgage is not justified and gives banks the wrong signal.

Treating IO loans as Category 2 by definition does not take into account the fact that when prudently underwritten, a bank's IO loan portfolio can perform just as well or better than its amortizing loan portfolio. In the analysis of one of our members, the experience of which is typical of the MBCA, as of December 2011, close to two-thirds of the bank's IO portfolio exhibited substantial equity in the borrower's home (where LTV is measured as current loan balance to original appraisal value). As indicated in the chart below, approximately 63% of the IO portfolio of this bank exhibited LTVs of 60% or better – over one-third (35%) had LTV's less than 50% or better.



Moreover, a comparison of the same bank's IO loan default rate to its amortizing loan default rate indicates a weighted average probability of default difference of only 1 basis point on a portfolio-wide basis.

Average Default Rates by LTV Bucket

2009-2011 Average	<= 50%	50.01-55%	55.01-60%	60.01-65%	5.01-70%	70.01-75%	5.01-80%	0.01-85%	5.01-90%	A.O.C	Grand Total
IO	0.33%	0.30%	0.64%	0.59%	1.27%	0.97%	0.59%	0.00%	0.00%	0.00%	0.57%
Amortizing	0.33%	0.77%	0.64%	1.27%	0.58%	0.87%	0.38%	13.89%	0.00%	1.85%	0.58%
Difference	0.00%	-0.47%	0.00%	-0.69%	0.69%	0.10%	0.20%	-13.89%	0.00%	-1.85%	-0.01%

2009-2011 Average Default By FICO Bucket

FICO RANGE	Interest Only	Amortizing	Difference
A) >=830	0.00%	0.00%	**0.00%**
B) 800-829	0.03%	0.00%	**0.03%**
C) 770-799	0.08%	0.02%	**0.05%**
D) 740-769	0.04%	0.02%	**0.02%**
E) 710-739	0.01%	0.01%	**0.01%**
F) 680-709	0.03%	0.03%	**-0.01%**
G) 650-679	0.05%	0.02%	**0.03%**
H) 620-649	0.05%	0.05%	**0.00%**
I) 590-619	0.19%	0.06%	**0.12%**
J) 560-589	0.03%	0.06%	**-0.03%**
K) <560	0.07%	0.28%	**-0.22%**
L) NO FICO	0.01%	0.03%	**-0.02%**
Grand Total	**0.57%**	**0.58%**	**-0.01%**

These data indicate that there is very little statistical difference in credit risk between the two portfolios, and that the proposed rules' approach in categorically excluding IO loans from the lowest risk-weighting is flawed. That a credit product is non-traditional does not in itself make it a higher risk asset; it is the creditworthiness of the consumer that is using the product that must be evaluated to determine the risk. A "disciplined consumer" should be allowed flexibility in choosing a credit product that fits their financial needs. Penalizing banks for using alternative credit products will only cause overall credit to become less available and more expensive.

The disconnect between the risk of a loan and the loan's treatment under the proposed rules also exists for low and no documentation loans. These loans will largely be ineligible for Category 1 treatment as the proposed rules permit a bank to determine a borrower's ability to repay only through "documented, verified income." Income is no doubt an important facet of a borrower's ability to repay and thus the risk of default. In the experience of our members, however, a high down payment (and thus a low LTV) coupled with a high FICO score is an even better indicator of that ability. This is because a high down payment and high FICO score are two hallmarks of a responsible borrower, and because a borrower who is no longer able to pay can more easily sell their house and pay back their loan if the loan has a low LTV.

By assigning higher risk-weights to low or no documentation loans without verified income, the proposed rules will force banks to restrict lending to only the long-term employee with a steady paycheck reflected on a W-2, in addition to improperly risk-weighting existing bank assets. The groups of creditworthy and deserving people negatively affected by the Category 1 requirements are diverse and numerous: small business owners, retired workers, the self-employed, workers with seasonal or short term jobs, casual union workers (such as long shore workers), independent contractors, and workers who are new in their job or who want to move their family to a new city to take a better job. The approach of the Agencies in the proposed rules is particularly unfortunate given the results of the FDIC's recently released National Survey of Unbanked and Underbanked Households, which urged banks to expand access to the credit system for those not currently served by the banking system.

The definitional exclusion of junior-lien mortgages from Category 1 treatment (except in the case in which no other party holds an intervening lien and the junior lien fully complies with the Category 1 requirements) similarly fails to take into account the true risk associated with a given loan. In reality, the risks associated with a junior lien vary greatly based on the amount of equity the borrower holds in the home and their ability to pay. We believe the risk characteristics of the relationship should be the driving factor in classifying a loan rather than the structure of the loan.

The MBCA urges the Agencies to eliminate the distinction between Category 1 and 2 loans and to tailor the risk-weighting of residential mortgage loans based on the underwriting standards used to make the loans. The Agencies should treat as prudently underwritten (and thus eligible for a low risk weight) loans that a bank extends only after determining the borrower's ability to repay as judged by (1) the borrower's documented, verified income, or (2) a low LTV ratio and high FICO score.

In the event the Agencies keep the Category 1/Category 2 framework, the Agencies should broaden the definition of Category 1 loans to encompass prudently underwritten loans, rather than only the most traditional loans.

B. Coordination with the CFPB Qualified Mortgage Provisions

The Consumer Financial Protection Bureau is evaluating industry comments concerning the definition of a Qualified Mortgage ("QM"). The final definition is critical for the industry because it will represent the standard for residential lending and afford a legal safe harbor for lenders. The consensus in the industry is that the QM definition should be as broad as possible to avoid restricting the availability of credit. One key factor in the qualification as a QM is the determination by the lender that the borrower has the ability to pay the mortgage. Regardless of the ultimate risk weight treatment of residential mortgage loans under the capital rules, and given the broad impact of the QM designation and its clear link to risk, we urge the Agencies to coordinate the underwriting standards included in the proposed capital rules with the final QM definition.

C. Exemption for Loan Modifications

If a mortgage is restructured or modified, the proposed rules require a bank to classify the mortgage in accordance with the terms and characteristics of the exposure after the modification or restructuring. Lenders are allowed to assign a lower risk weight provided they update the LTV ratio at the time of the modification, but are also required to assign a high risk weight if necessary. If the rules are finalized in their current form, this provision provides a powerful disincentive to banks which might otherwise modify or restructure loans, but will not do so where they would be forced to hold the loan at a higher risk-weight. Loans modified or restructured solely pursuant to the Home Affordable Mortgage Program ("HAMP"), however, are not considered modified or restructured for purposes of this section. The exemption encourages banks to modify and restructure loans, as banks are not required to revisit the risk-weighting treatment of the loan (even though, once modified, the loan has a higher LTV ratio). We urge the Agencies to broaden this exemption from re-categorization of loans to include private modifications and restructurings not completed under HAMP.

D. Grandfathering Existing Loans

The MBCA believes the Agencies should grandfather residential mortgages which were originated under the existing capital rules. Although banks can adjust their lending practices to accommodate the treatment of residential mortgages going forward to avoid some of the more punitive risk weights, they cannot do so with respect to loans already made. To penalize banks now for long-term decisions made under a previous regulatory regime would work a substantial injustice far into the future. Moreover, many banks might not have the data needed to classify existing loans and may find such data difficult, if not impossible, to obtain. Even where they can find the data, bank staff would be required to undergo the extremely burdensome process of going through decades-old loan files to obtain the information.

The substantial increase in the capital that would be required for these loans, which may constitute a substantial amount of assets on an institution's balance sheet, and the retroactive impact of the proposed treatment would be especially harsh. Given that the proposed capital rules already substantially increase the required minimum capital, the need for retroactive application of the new standards is significantly attenuated. In addition, to the extent that loans originated under existing regulations and capital rules truly do reflect more risk to a bank that holds those loans, additional capital should already exist on those portfolios through the ALLL. Providing additional capital for those loans on top of what is already in the ALLL would be a mistake in our view. We believe any final rule should grandfather all existing mortgage exposures by assigning them risk weights as required under the current general risk-based capital requirements (*i.e.*, 50% risk weight).

VII. Treatment of High Volatility Commercial Real Estate

The proposed capital rules would assign a high risk weight of 150% to exposures defined as High Volatility Commercial Real Estate ("HVCRE"). Any credit facility that finances or has financed the acquisition, development, or construction of a commercial real estate project will be defined as HVCRE unless, among other things,

> (ii) The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 % of the real estate's appraised "as completed" value.

We believe the choice of using "as completed" versus "project cost" or "stabilized value" adds unnecessary uncertainty to this definition. While the proposed language may be technically correct, it fails to address tenant improvements, leasing commissions and interest expense after completion. As a result, as drafted, this provision in the proposed rules would require a higher percentage of cash to total cost than 15%, which we do not believe was the Agencies' intent. Separately, the Agencies have failed to provide a definition of the term "readily marketable assets." Below we provide four scenarios in which this language will create problems.

First, our members have clients who have owned their land for many years, in one case dating back to the 18th century, and carried it at zero cost on a GAAP basis. When the land is provided free and clear of liens as collateral to a loan, along with potential other cash equity depending upon the loan structure and appraised valuation, the resulting LTV is well below the maximum supervisory loan-to-value ratio. However, in these cases there is likely not 15% *cash* equity. Instead there is substantial *appraised* equity which results in a conservative LTV. To accommodate such cases, it is our opinion that this provision should permit the appraised equity to account for the required equity in a project so long as the maximum LTV is below the maximum supervisory value. Long-term holders of land should not be singled out and punished by the equity requirement.

Second, in many cities in California, entitlements to build are very difficult to obtain. Land may be purchased at a very low cost if, among other possible circumstances, the entitlements at the time of purchase only allow a single-family residence to be built on the land. However, if the owner of the land goes through the often lengthy and difficult process of changing the entitlements such that the land can be used in a "highest and best" fashion, significant equity can be created. If, for example, the aforementioned single-family residential lot was later entitled for the construction of a 50-unit apartment building, significant value would have been created, thereby allowing for a conservative construction loan to be made well within the maximum supervisory LTV ratio and well below a bank's policy LTV. However, as in the example above there is likely not 15% *cash* equity. Instead there is substantial *appraised* equity which results in a conservative LTV. Here again, the same rationale for allowing for appraised equity to account for the required equity in a project so long as the maximum loan-to-value is below the maximum supervisory value applies. Those property owners who create value through an entitlement change resulting in a use that is "highest and best" should not be singled out and negatively impacted by this requirement.

Third, the "as completed" value is an opinion of an appraiser. Accordingly that value could very likely differ between two different appraisals of the same asset. This has the potential to create unfairness to different borrowers building similar projects. We believe the 15% cash equity requirement should be calculated against the "project cost" as opposed to the "as completed" value. The definition already requires that the loan not exceed the supervisory maximum LTV, which prevents a bank from making a loan on a project that is infeasible. Real estate investors should not be singled out and potentially negatively impacted by differing opinions of value as potentially created by this requirement.

Fourth, the "as completed" value, again a subjective value arrived at in the appraisal process, could be the same value as the "stabilized" value. This would be the case, for example, where the proposed to-be-built building were pre-leased, for instance on a long term basis to a single tenant that carries an Investment Grade rating. The signing of a lease to this type of tenant creates significant value and again, as with the prior examples, allowing for a conservative construction loan to be made well within the maximum supervisory loan-to-value ratio, but without necessarily having 15% cash equity to the "as completed" value. For this reason as well, we believe the 15% cash equity requirement should be calculated against the "project cost" as opposed to the "as completed" value. Here again, the definition's requirement that the loan not exceed the maximum supervisory LTV prevents a bank from making a loan on a project that is infeasible. Those property owners who create value through the execution of a lease or leases, should not be singled out and negatively impacted by this requirement.

VIII. Capital Conservation Buffer

The proposed capital rules would mandate a capital conservation buffer to incentivize banks to maintain their common equity tier 1 capital, Tier 1, and total capital ratios above the required minimums. Banking organizations would need to hold capital conservation buffers in order to avoid being subject to limitations on capital distributions and discretionary bonus payments to executive officers.

We believe the capital ratios adjusted for the capital conservation buffer will function as a de facto minimum capital requirement since most institutions need and desire the flexibility to make capital distributions to shareholders and appropriately reward executive management. As the Agencies are well aware, market and supervisory preferences will force banking organizations to hold capital in excess of this de facto minimum, essentially leading to additional "buffers" being maintained in excess of the required "buffers." The result, especially when combined with other provisions creating volatility in capital ratios such as the treatment of AOCI on AFS securities, will be to put banks in an extremely defensive position regarding the holding of capital in excess of regulatory requirements. This may significantly curb the ability of banks to extend credit. The Agencies should consider removing the requirement for a capital conservation buffer, or, at a minimum, carving out an exemption from it for small and mid-sized banks engaged primarily in traditional banking activities.

IX. Transition Periods

A. Treatment of Trust Preferred Securities

The Capital Proposal would phase out trust preferred securities ("TruPS") and other non-qualifying capital instruments issued by depository institution holding companies with total consolidated assets of $15 billion or more ratably over a 3-year period beginning in 2013, with full phase-out occurring on January 1, 2016. In contrast, Basel III suggests phasing out such instruments ratably over a 10-year horizon beginning in 2013, with full phase-out occurring on January 1, 2022.

The MBCA understands that Section 171 the Dodd-Frank Act requires the phase out of such instruments over a 3-year period. However, Section 171 does not require a phase out in the aggressive 25% increments contemplated in the proposed capital rules. Moreover, over the Agencies' proposed phase-out period, foreign institutions of $15 billion or more subject to the Basel III phase-out timeline would be able to include more TruPS in regulatory capital than U.S.

institutions over the 3-year period. In other words, while a foreign institution of $15 billion or more would be permitted to include 90% of its TruPS in Tier 1 in 2013, a similar U.S. BHC or SLHC would be allowed to include only 75%. In year two, the foreign institution would be allowed to include 80%, while the U.S. institution could include only 50%, and so on.

Although U.S. institutions will ultimately be put a a competitive disadvantage during the later Basel III phase-out period, in order to minimize this disadvantage, and to give U.S. institutions additional flexibility to phase out non-qualifying capital instruments in an orderly and less punitive fashion, we suggest the Agencies phase-out non-qualifying capital instruments issued by such institutions in 10% increments in each of 2013 (i.e., 90% includable in Tier 1), 2014 (80% includable in Tier 1) and 2015 (70% includable in Tier 1), with full phase-out occurring in 2016. This phase-out schedule is fully compliant with the Dodd-Frank Act.

B. Competitive Disadvantage with Treatment of Goodwill

Although the proposed rules preserve the existing deduction of goodwill, including goodwill embedded in the valuation of significant investments in unconsolidated financial institutions, the rules differ from Basel III in that these deductions are immediately applicable (*i.e.*, in 2013), whereas Basel III phases in the deduction of goodwill over the period from 2014 through 2018. The Agencies should adopt the Basel III phase-out framework as it pertains to goodwill in order to prevent U.S. institutions from being further disadvantaged relative to their global competitors.

* * *

The MBCA appreciates the opportunity to express our concerns and suggestions on the proposals. We look forward to discussing these matters with you in the future.

Yours Truly,

Russell Goldsmith
Chairman, Midsize Bank Coalition of America
Chairman and CEO, City National Bank

cc: Mr. Jack Barnes, People's United Bank
Mr. Greg Becker, Silicon Valley Bank
Mr. Daryl Byrd, IBERIABANK
Mr. Carl Chaney, Hancock Bank

Mr. William Cooper, TCF Financial Corp.
Mr. Raymond Davis, Umpqua Bank
Mr. Vince Delie, F.N.B Corp.
Mr. Dick Evans, Frost National Bank
Mr. Mitch Feiger, MB Financial, Inc.
Mr. Philip Flynn, Associated Bank
Mr. Paul Greig, FirstMerit Corp.
Mr. John Hairston, Hancock Bank
Mr. Robert Harrison, First Hawaiian Bank
Mr. Peter Ho, Bank of Hawaii
Mr. Gerard Host, Trustmark Corp.
Mr. John Ikard, FirstBank Holding Company
Mr. Bob Jones, Old National
Mr. Bryan Jordan, First Horizon National Corp.
Mr. David Kemper, Commerce Bancshares, Inc.
Mr. Mariner Kemper, UMB Financial Corp.
Mr. Gerald Lipkin, Valley National Bank
Mr. Stanley Lybarger, BOK Financial
Mr. Dominic Ng, East West Bank
Mr. Joseph Otting, One West Bank
Mr. Joe Pope, Scottrade Bank
Mr. Steven Raney, Raymond James Bank
Mr. William Reuter, Susquehanna Bank
Mr. Larry Richman, The PrivateBank
Mr. James Smith, Webster Bank
Mr. Scott Smith, Fulton Financial Corp.
Mr. Carlos J. Vazquez, Banco Popular North America
Mr. E. Philip Wenger, Fulton Financial Corp.

Mr. Michael Cahill, Esq., City National Bank
Mr. Brent Tjarks, City National Bank

Mr. Drew Cantor, Peck, Madigan, Jones & Stewart, Inc.
Mr. Jeffrey Peck, Esq., Peck, Madigan, Jones & Stewart, Inc.

Mr. Richard Alexander, Esq., Arnold & Porter LLP
Ms. Nancy L. Perkins, Esq., Arnold & Porter LLP
Mr. Andrew Shipe, Esq., Arnold & Porter LLP