American Bankers Association

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Re: Community Bank Leverage Ratio

Ladies and Gentlemen:

The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the federal banking agencies' (Agencies) proposed rule establishing a Community Bank Leverage Ratio (CBLR Proposal).[2] This CBLR Proposal seeks to implement Section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (Economic Growth Act). Subject to the comments below, ABA is supportive of the CBLR Proposal.

The CBLR Proposal recognizes what several years of bank supervision have shown, that a large number of U.S. banking organizations and depository institutions are so highly capitalized that they clearly meet or significantly exceed the risk-based capital requirements and "well capitalized" designation of the Agencies' Prompt Corrective Action (PCA) regulations. Yet today these institutions must spend the time, effort, manpower, and expense to maintain systems and make the necessary calculations to demonstrate their compliance with these unnecessarily complex capital requirements, which are a poor fit for many of our nation's banking organizations. Implementation of the CBLR would reduce the wasteful allocation of resources to

[1] The American Bankers Association is the voice of the nation's $18 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard nearly $14 trillion in deposits, and extend more than $10 trillion in loans.
[2] See Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations, 84 Fed. Reg. 3602 (proposed Feb. 08, 2019).

comply with these processes for the banking organizations that would meet or exceed such requirements. These highly capitalized banks could deploy the resources expended today calculating their minimum risk-based capital ratios more productively elsewhere. More importantly, the CBLR's development now will create an optional framework that should enable well capitalized community banks to avoid the costs of implementing future changes to the risk-based capital rules.

ABA supports efforts to simplify and improve the current regulatory capital framework for banks. Over the last two decades, the regulatory capital framework has grown more complex than it needs to be for the financial stability or supervisory value it provides. The CBLR is an important component to achieving a simpler and better regulatory capital framework for community banks. We not only encourage the Agencies to continue this effort, but we encourage further efforts to simplify the generally applicable risk-based capital standards to address unnecessary complexity, particularly for provisions that needlessly inhibit economic growth or constrain banks in fulfilling their core functions.

In this letter, ABA offers its recommendations for how the CBLR Proposal and the generally applicable risk-based capital standards can be improved. ABA's letter is organized as follows:

- Section 1 provides background on the CBLR proposal.
- Section 2 emphasizes why the CBLR must remain optional at all times and discusses the implications of the proposed PCA framework.
- Section 3 discusses why a CBLR ratio of 8% is adequate for a bank to be deemed "well capitalized."
- Section 4 discusses the appropriate definition of capital as well as the limiting factors.
- Section 5 includes additional improvements to the generally applicable capital standards that the Agencies should seek to implement.

1. Background on the CBLR Proposal.

Section 201 of the Economic Growth Act requires the Agencies to issue a rule creating a "Community Bank Leverage Ratio," which they can set anywhere between 8% and 10%. If a "qualifying community bank" is above the ratio, it will be deemed well capitalized and in compliance with risk-based capital requirements such as Basel III. Section 201 is a welcome recognition that many community banks maintain capital levels far in excess of any amounts that would be required by the complex evaluations, measurements, and calculations mandated under the Basel III regulations. For these highly capitalized banks, the considerable and costly work of applying Basel III and related reporting framework yield no additional supervisory, safety and soundness, or customer benefit.

Section 201(a) sets out criteria governing eligibility for compliance with the CBLR by defining a "qualifying community bank" as a bank with total consolidated assets of less than $10 billion, while also authorizing the Agencies to establish other qualifying criteria governing eligibility for the CBLR, based on a consideration of the risk profile of qualifying community banks.

The Agencies' CBLR Proposal defines a qualifying community banking organization as a depository institution or depository institution holding company with less than $10 billion in total consolidated assets that has limited amounts of off-balance sheet exposures, trading assets and liabilities, mortgage servicing assets (MSAs), and deferred tax assets (DTAs) arising from temporary differences that a banking organization could not realize through net operating loss carrybacks (temporary difference DTAs).

The CBLR would be measured as the ratio of tangible equity capital (CBLR tangible equity) divided by average total consolidated assets. Under the proposal, CBLR tangible equity would be defined as total bank equity capital or total holding company equity capital, as applicable, prior to including minority interests, and excluding accumulated other comprehensive income (AOCI), DTAs arising from net operating loss and tax credit carryforwards, goodwill, and other intangible assets (other than MSAs), each as of the most recent calendar quarter and calculated in accordance with a qualifying community banking organization's regulatory reports.

As currently proposed, a qualifying community banking organization may opt in to use the CBLR framework when it has a CBLR of at least 9 percent. The CBLR Proposal also provides an alternative PCA framework for banks that have opted in to the CBLR and have had their CBLR subsequently fall below 9 percent. Specifically, for insured depository institutions, the proposal incorporates CBLR levels as proxies for the following PCA categories: adequately capitalized, undercapitalized, and significantly undercapitalized. If a CBLR banking organization's CBLR meets the corresponding CBLR PCA levels, it would be considered to have met the capital ratio requirements within the applicable PCA category and be subject to the same restrictions that currently apply to any other insured depository institution in the same PCA category.

As currently proposed, the alternative PCA framework is more punitive than the existing PCA framework, recognizing that banks have the right to opt out of the CBLR at any time.

The CBLR Proposal is not designed to reduce the amount of regulatory capital banks need. Rather, it is designed to relieve the unnecessary regulatory reporting of risk-based standards for eligible community banks. If properly designed, the CBLR Proposal should reduce wasteful allocation of resources—such as reducing staff time, outside audit costs, and even examination time, for eligible institutions.

2. The CBLR must remain optional at all times.

The Agencies have proposed a flexible framework that allows qualifying institutions to opt in at any time. In addition, banks that have opted in to the CBLR framework are permitted to opt out of CBLR framework at any time by using the generally applicable capital requirements and completing the associated reporting requirements. ABA supports a flexible and optional CBLR regime.

However, in its comment letter responding to the CBLR Proposal, the Conference of State Bank Supervisors raised questions about how optional the CBLR framework would be in practice.

Some ABA members share these concerns, particularly for the following potential circumstances:

- There are concerns that banks could be forced to opt in to the CBLR framework if their peers in their community opt in to the framework. These bankers believe that local examiners will view banks that do not opt in to the framework as outliers and pressure them to raise capital and opt in to the framework.
- There are concerns that banks could be trapped within the CBLR framework by local examiners, even as their capital levels decline below the CBLR, by process issues that would make it too difficult in practice for banks to opt out.

Both of these concerns stem from past experiences during the financial crisis where examiners used every possible tool to get banks to raise additional capital. If either of these two circumstances were to occur, banks are concerned that they would be bound to the extremely conservative PCA proxies envisioned in this CBLR Proposal with no way to opt out. In effect, the apprehension is that the regulatory language to implement Congress' effort to provide and optional avenue for community bank relief could be transformed into a supervisory tool used to mandate more capital.

Through examiner training, more transparency on bank ratings, and other appropriate steps, the Agencies must reinforce the optionality envisioned in the CBLR Proposal. The Agencies need to clarify that a bank can opt out at any time. We would note, moreover, that concerns about the proposed PCA proxies become significantly diminished were the CBLR set at 8 percent, as described and recommended in Section 3 of this letter.

3. The CBLR should be calibrated to 8 percent.

The Agencies emphasize that the CBLR Proposal is not intended to reduce the amount of regulatory capital that banks need. Rather, it is designed to be a regulatory relief measure for banks that can already demonstrate they meet the Basel III standards. We agree with this purpose and believe the purpose is served with an 8 percent CBLR.

By ABA's calculations, every single qualifying community bank that has an 8 percent CBLR is already meeting the well capitalized risk-based capital ratios. ABA's calculations show that an 8 percent CBLR serves as an effective proxy to determine whether an institution is otherwise "well capitalized." Setting the CBLR at 9 percent is unnecessary, but it will significantly limit the number of institutions eligible for the relief that Congress intended.

We would also note that banks effectively maintain capital buffers above minimum regulatory capital requirements. If the CBLR were calibrated at 8 percent, we anticipate that only banks with a comfortable buffer above 8 percent would be interested in opting in to the CBLR framework. In practice, 8 percent could become 9 percent, or 10 percent, or higher. Similarly, setting the CBLR at 9 percent, banks would operationally consider the need to hold 10 percent, or 11 percent, or more in capital.

In addition, we believe that the adoption of the planned current expected credit loss standard (CECL) could impact the number of institutions eligible for CBLR relief, especially during an economic downturn. We believe that CECL will not only increase credit loss reserves but also the volatility of those reserves at community banks. Such increases will be at the expense of, and serve the same purpose as, regulatory capital, with the potential volatility requiring further buffers on top of those just discussed. The ability of these increases of reserves to absorb losses further justifies setting the CBLR calibration at the lower 8 percent bound.

The Agencies should finalize the CBLR Proposal with the "well capitalized" PCA category set at a CBLR of 8 percent. Should the Agencies maintain the alternative PCA framework, adequately capitalized, undercapitalized, and significantly undercapitalized PCA categories should similarly be adjusted as follows:

- Adequately capitalized—CBLR of 6 percent or greater;
- Undercapitalized—CBLR of less than 6 percent; and
- Significantly undercapitalized—CBLR of less than 4.5 percent.

4. Subject to the finalization of the regulatory deduction proposal, the CBLR should be defined as the Tier 1 Leverage Ratio and the qualifying criteria should be simplified.

The Agencies have proposed a simple and reasonable definition of "tangible equity." However, it is clear the Agencies are concerned about certain asset classes, because they have also included various qualifying criteria. For example, banks with mortgage servicing asset (MSA) concentrations that exceed 25 percent of tangible equity would not be considered qualifying banking organizations. These qualifying criteria are an unnecessary complexity.

Instead of adopting a simple numerator with complex qualifying criteria, the Agencies should—

- Finalize the regulatory deduction proposal issued in 2017;
- Use the revised Tier 1 leverage ratio that reflects the new deduction methodology as the CBLR; and,
- Eliminate the qualifying criteria that relate to assets deducted from Tier 1 capital.

Community banks are already familiar with the calculation of Tier 1 capital, and the Tier 1 leverage ratio would not require any changes to internal processes. Moreover, use of a Tier 1 leverage ratio will facilitate the ability of investors and bank supervisors to compare capital adequacy across community banks within the CBLR Framework and those outside the Framework. The use of Tier 1 capital will also ensure that certain instruments that have been issued by community banks, such as Trust Preferred Securities (TruPS) and common stock issues by bank subsidiaries, will be counted as capital, up to the limits imposed by Basel III rules.

Future adjustments need to be made to accommodate accounting changes.

ABA continues to monitor the impact on community banks of the upcoming implementation of the current expected credit losses standard (CECL). A recent survey performed by ABA suggests that CECL reserves would spike in a stressed economic environment. If applied to community banks, the surveyed reserve levels might disqualify many from qualifying for the CBLR. More work is required, however, since most community banks are still in the beginning stages of model development. Therefore, due to the still uncertain impact, ABA first recommends that the Agencies provide for an ongoing adjustment to the numerator used in the CBLR that approximates the incremental regulatory capital impact of CECL credit loss allowance levels over levels currently recorded. Until a long-term recalibration of the regulatory capital framework can be completed, incremental allowances required under CECL after the effective date can be estimated through use of streamlined proxy incurred loss methods to mitigate the operational challenges of estimating the differences on an ongoing basis. Such an adjustment will allow time for the Agencies to determine how to integrate the higher loss absorbency aspect of CECL into the capital framework.

The Agencies can avoid embracing arbitrary thresholds.

ABA understands that Section 201 requires the Agencies to develop a CBLR for institutions with $10 billion or less in consolidated assets. However, Section 201 places no limit on the ability of the Agencies to apply a CBLR to institutions with above $10 billion in assets. ABA encourages the Agencies to tailor application of the CBLR to institutions based on their suitability for relief from the generally applicable risk-based capital standards and not base this relief on arbitrary asset thresholds.

Arbitrarily set thresholds are inapt, fixed dividing lines for banks that fail to capture market dynamics when established and become worse over time as they perpetuate market distortions. Inevitably, the proposed static threshold in the CBLR Proposal will come to exclude banks which were originally eligible for this relief but have grown, even if only marginally. ABA believes that in addition to tailoring application of the CBLR threshold to institutions based on their suitability for relief, not their asset size, the Agencies should index applicability to take into account inflation or other relevant market measures.

Off balance sheet exposures key to the functioning of mortgage markets should be excluded from off-balance sheet qualifying criteria.

ABA is concerned that certain exposures related to safe functioning of the mortgage market may be captured by the "off balance sheet" qualifying criteria. Many community banks operate mortgage pipelines where loans are originated, seasoned, and eventually sold to GSEs or private label securitizers. Proper risk management of these pipelines of loans proceeding through the origination process and originated loans Held for Sale often include various hedging techniques[3]

[3] For instance, selling forward and reverse "TBA" Mortgage Backed Securities contracts; purchasing put and call options on forward & reverse Mortgage Backed Securities contracts; and, cash window loan delivery commitments to GSEs.

that could be captured by the off balance sheet qualifying criteria as currently written. Since these transactions lower the credit risk and interest rate risk of a bank, we believe that the Agencies should welcome this activity and not penalize it. ABA recommends that this type of mortgage origination related hedging activity be excluded from any limiting factor that excludes banks from being able to use the CBLR Framework.

Similarly, we are concerned that mortgage sales to certain Federal Home Loan Banks (FHLB) through their Mortgage Partnership Finance Program might also be captured by the off balance sheet qualifying criteria. Over1,000 banks nationwide use the MPF Program to transfer the liquidity risk, interest rate risk, and prepayment risk of their long-term, fixed-rate mortgages, while retaining a portion of the credit risk through a credit enhancement obligation provided to their FHLB. We note that these activities are already reviewed by the Agencies during the periodic bank examination process, which is a more appropriate risk management process than encumbering the CBLR and/or Call Report data for this purpose.

5. The Agencies should make additional changes to the risk-based capital standards.

ABA supports efforts to simplify and improve the current regulatory capital framework for community banks, which is an important and necessary undertaking. The CBLR is a valuable component to achieving a simpler and better regulatory capital framework for qualifying banks. However, equally important is the Agencies' efforts to simplify the generally applicable risk-based capital standards to address unnecessary complexity, particularly for provisions that needlessly inhibit economic growth or without adequate supervisory value constrain community banks in fulfilling their core functions.

<u>The Agencies should finalize the proposed regulatory deduction revisions.</u>

In 2017, the Agencies issued a proposal entitled "Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996" (Simplification Proposal). The comment period on the Simplification Proposal closed on December 26, 2017. However, this proposal has still not been finalized. Promptly finalizing the regulatory deduction component of the Simplification Proposal would provide immediate benefits to banks and their customers.[4]

[4] The regulatory deduction provisions are among the more complex aspects of the Basel III final rule. Generally, the provisions include an individual deduction threshold set at 10% of common equity tier 1 (CET1) as well as an "aggregate deduction threshold" for various groups of assets set at 15% CET1. The combination of individual and aggregate deduction thresholds is unnecessarily complex and unwieldy, particularly for community banks. For example, the final rule includes a sixteen box flow chart for the treatment of investments in the capital of unconsolidated financial institutions. Such complexity offers little value for bank supervisors or bank management. The banking industry supports the Simplification Proposal's elimination of the 15% deduction limit. Furthermore, we support raising the individual deduction thresholds for mortgage services assets, investments in the capital instruments of unconsolidated financial institutions, and deferred tax assets resulting from timing difference from 10% to at least 25%. While we believe it is also important for the Agencies to reconsider the risk weight treatment of the portion of exposures that are not deducted from capital, we do not believe that this reconsideration should slow the finalization of this rule.

The Agencies should revisit the deduction of investments in other financial institutions.

Many community banks have held capital investments in other financial institutions for decades. Until recently, these instruments have been held on a cost basis. The regulatory deduction threshold was generally not a major concern for these banks until the Financial Account Standards Board adopted ASU 2016-01, which requires banks to carry these instruments at fair value. As a result of the accounting change, and the relatively high fair value relative to cost basis, ABA is increasingly concerned about the regulatory deduction threshold even if it is increased to 25% of common equity. The Agencies should increase the regulatory deduction threshold beyond 25% and explore ways to limit volatility associated with the accounting change.

The Agencies should eliminate the capital conservation buffer.

The Agencies should also eliminate the capital conservation buffer for community banks, because it is redundant with PCA and penalizes Subchapter S banks. Under the Subchapter S rules, shareholders are required to pay federal income taxes on a firm's profits proportionate to the shareholders' ownership interest in the company, regardless of whether profits are actually distributed to the shareholders. Generally, shareholders are able to meet their tax obligations from distributions they receive from the S-Corp bank. However, under the capital conservation buffer requirements, a bank may be limited or prohibited from making such distributions if the bank's capital levels fall below the required capital buffer, even though the bank is profitable enough to incur a tax liability. In such a case, the tax obligation would remain, forcing the bank's shareholders to pay taxes on income that they have not received, placing the S-Corp bank at a funding competitive disadvantage relative to its C-Corp counterparts. The capital conservation buffer is harmful to the growth and viability of S-Corp community banks, especially in times of economic stress. Further, the conservation buffer impedes Congressional intent in creating the S-Corp category to stimulate investment in small businesses.

Thank you very much for considering these issues. If the Agencies would like additional information regarding these comments, please contact Hugh Carney at (202) 663-5324.

Sincerely,

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American Bankers Association