BANKERS' BANK OF THE WEST

April 9, 2019

Via Email: regs.comments@federalreserve.gov
Ms. Ann Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

re: Docket No. R–1638

Via Email: comments@FDIC.gov
Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

re: FDIC RIN 3064-AE91

Via Email: regs.comments@occ.treas.gov
Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, S.W., Suite 3E–218
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re: Docket ID OCC–2018–0040

Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations

Ladies and Gentlemen;

Bankers' Bank of the West and the twenty-eight community financial institution signatories to this comment letter (collectively "Responders") appreciate the opportunity to comment on potential actions of the Federal Reserve Bank, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency ("Agencies") to support capital simplification for qualifying community banking organizations.

The Responders are supportive of the Agencies efforts to reduce the regulatory burden of calculating, maintaining, and monitoring capital levels as proposed in the February 8, 2019 Federal Register Notice. The Responders agree, as the Agencies assert, that an optional, simplified measure of capital adequacy for qualifying community banking organizations would provide material regulatory relief by providing the option to calculate a simplified on-balance sheet leverage ratio to measure capital adequacy.

- Board of Governors of the Federal Reserve System (Docket No. R–1638);
- Federal Deposit Insurance Corporation (Docket ID OCC–2018–0040);
- Office of the Comptroller of the Currency (Docket ID OCC–2018–0040)

Introduction

Bankers' Bank of the West has been a partner to hundreds of community financial institutions for over 38 years, providing credit, liquidity, risk management solutions, and gateways to payment systems, allowing those financial institutions to remain competitive as markets evolve, while maintaining a proud legacy as a champion of community banking. Community financial institutions have relied on bankers' banks, corporate credit unions, and other correspondent service providers as trusted partners. Bankers' Bank of the West is one of 12 bankers' banks in the nation that collectively serve the needs of approximately 5,000 community financial institutions across the U.S.

Part of the role played by Bankers' Bank of the West with its respondent financial institutions is in assisting and managing credit risk and liquidity through avenues such as daily transaction settlement, pass-through reserves, and excess balance account agent with the Federal Reserve.

Comments on the Capital Simplification for Qualifying Community Banking Organizations

There are many considerations regarding the Agencies' recommendations regarding capital simplification. While efforts in this matter have been ongoing for some time, there is a significant knowledge gap for many smaller financial institutions that may not have had the resources or awareness to dedicate to this topic. This comment letter is representative only of Bankers' Bank of the West and other signatories, however we believe the general opinions of community financial institutions are reflected in the following three sections.

Background on the Community Bank Leverage Ratio Proposal

In May 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act was signed in to law. As a result of this Act the Agencies put forth a proposal in November 2018 to simplify regulatory capital requirements for qualifying community banking organizations.

Community banking organizations with less than $10 billion in total consolidated assets and limited amounts of certain assets and off-balance sheet exposures ("Qualifying Banks") would receive regulatory burden relief through an option to calculate a simple leverage ratio, rather than multiple measures of capital adequacy. A Qualifying Bank would be eligible to elect the community bank leverage ratio ("CBLR") framework allowing for a ratio greater than 9 percent and not be required to calculate the existing risk-based and leverage capital requirements. A Qualifying Bank would also be considered to have met the capital ratio requirements to be well capitalized for the Agencies' prompt corrective action rules provided it has a CBLR greater than 9 percent.

The Community Bank Leverage Ratio Should be Calibrated to 8 Percent

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

Our review of call report information demonstrates that of 4,943 community financial institutions with less than $10 billion in total assets as of December 31, 2018, 86.0% had a leverage ratio of more than 9 percent and a risk-based capital ratio higher than 10.5 percent. Reducing the leverage ratio limit to 8 percent expands that to 96.7%, allowing an additional 529 Qualifying Banks to participate.

Further, call report data for December 31, 2009 shows only 55.1% of Qualifying Banks had a leverage ratio in excess of 9 percent with risk-based ratios over 10.5 percent. Comparing the population to one using an 8 percent minimum would increase those eligible Qualifying Banks to 77.0%. (It is understood that the fully-implemented Basel III standards with capital conservation buffer had not been adopted.)

As a result, the Respondents believe that an 8 percent CBLR is an effective proxy to determine whether an institution is otherwise "well capitalized". Setting the CBLR at 9 percent is unnecessary and will significantly limit the number of institutions eligible for relief.

We also note that Qualifying Banks would maintain self-determined capital buffers above any regulatory capital thresholds. The Respondents anticipate that only Qualifying Banks with a comfortable buffer above 8 percent would be interested in opting in to the CBLR framework, so by reducing the threshold to 8 percent, wider acceptance of the CBLR framework.

The Community Bank Leverage Ratio Must Always Remain Optional

The Agencies proposal reflects a flexible framework that allows Qualifying Banks to opt-in at any time and those Qualifying Banks that have opted in to the CBLR framework will be permitted to opt-out of CBLR framework at any time by returning to the accepted capital requirements and completing the associated reporting requirements. The Respondents support such a CBLR regime.

Questions have been raised about how optional the CBLR framework would be in practice.

- Qualifying Banks have expressed concerns that they could be forced to opt-in to the CBLR framework if peers in their community opt-in to the framework. At the heart of the concern is that local examiners will view Qualifying Banks that don't opt-in to the framework as outliers and pressure them to opt-in to the framework to raise capital levels.
- Qualifying Banks are also afraid they could be trapped within the CBLR framework by local examiners even as their capital levels decline.

These concerns stem from experiences during the financial crisis and if Qualifying Banks are forced to opt-in, or become trapped in, the CBLR, the proposal could constitute a significant increase in the capital requirements for community banks.

The success of the optionality within the CBLR can be assured through examiner training, greater transparency on bank ratings, and communication with examined Qualifying Banks. The Agencies need to clarify that a Qualifying Bank can opt-out at any time without prior approval or notice.

Other Considerations for the Community Bank Leverage Ratio

The Agencies should consider and accommodate changes accounting in accounting standards

Several accounting changes are currently being adopted or are forthcoming that will have a yet undetermined impact on the balance sheets of Qualifying Banks and may have result in less acceptance of the CBLR until fully implemented. These accounting changes include:

- The current expected credit losses methodology (CECL). The Respondents request the Agencies allow for the potential impact to capital from either an initial adjusting provision to the allowance for loan and lease losses or factor in the allowance to the calculation of the numerator. CECL is expected to increase reserves and the volatility of reserves at most Qualifying Banks and that those increases in reserves will be funded through, and serve as a proxy for, regulatory capital. The ability of these expected allowance increases to absorb loan and lease losses further justifies lowering the CBLR limit. Without such consideration, the adoption of CECL could impact the number of Qualifying Banks eligible for CBLR relief.

- Right-of-Use Asset Accounting Standards (ASU 2016-02). While it is unclear how much leased property is currently held by Qualifying Banks, this could result in a reduction in the CBLR without any impact to the capital held by the institution. Under the new standard, Qualifying Banks will be required to record a right-of-use asset for leased property (also recording a corresponding lease liability). This right-of-use asset will be amortized to expense over the lease term and lease payments will reduce the lease obligation, rather than the current approach of expensing lease payments as they are made under operating lease guidance. The standard is effective for many Qualifying Banks beginning January 1, 2020.

- Recognition and Measurement of Financial Assets and Financial Liabilities (ASU 2016-01). Many community banks have held capital investments in other financial institutions for decades and such investments have historically been held on a cost basis. ASU 2016-01 requires banks to carry these instruments at fair value. There have been concerns expressed 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 define the numerator of the CBLR as Tier 1 capital

This would further reduce the regulatory burden when transitioning into and out of the CBLR framework. The use of a Tier 1 leverage ratio preserves the ability of examiners when comparing capital adequacy across Qualifying Banks, regardless of their adoption of the framework. This further avoids necessitating revisions to any state banking laws that reference Tier 1 capital, including but not limited to legal lending limits defined in state law. The continued ability to use Tier 1 capital would also continue to allow Qualifying Banks to include certain instruments in their capital calculations.

The Agencies should evaluate the size threshold for current and future bank needs

Section 201 of the Economic Growth, Regulatory Relief, and Consumer Protection Act mandates that the agencies develop a CBLR for institutions below $10 billion in consolidated assets. It does not, however, limit the ability of the Agencies to apply a CBLR to institutions above $10 billion. Under the proposal, the Agencies utilize that $10 billion limitation to determine the Qualifying Banks. This threshold is static and does not consider inflation and acquisition activity that may push a Qualifying Bank above $10 billion in consolidated assets. Increasing the threshold, indexing the limit based on community banking organization sizes and structures, or creating some other means of flexibility in this limit would ensure that banks that maintain their community bank identities are not burdened with unnecessary regulation. This is reflected over the same period of December 2009 to December 2018 during which 15-20 banks eclipsed the $10 billion threshold but continue to invest and operate like community banks.

- Board of Governors of the Federal Reserve System (Docket No. R–1638);
- Federal Deposit Insurance Corporation (Docket ID OCC–2018–0040);
- Office of the Comptroller of the Currency (Docket ID OCC–2018–0040)

The Agencies should eliminate the capital conservation buffer

As published, the Regulatory Capital Rule[1] notes that "Qualifying community banking organizations that elect to be under the community bank leverage ratio generally would be exempt from the Board's current capital framework, including risk-based capital requirements and capital conservation buffer requirements."

Under Subchapter S rules, shareholders pay federal income taxes on a bank's profits proportionate to the shareholders' ownership interest in the bank – regardless of whether profits have been distributed to the shareholders (as is generally the practice). However, the capital conservation buffer requirements may limit or prohibit a bank from making such distributions if capital levels fall below the required capital buffer – even though the bank may be 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 and placing the Subchapter S bank at a disadvantage compared with their C Corporation counterparts. The capital conservation buffer is may limit the growth and perhaps even viability of Subchapter S community banks (especially in times of economic stress), contrary to the purpose in creating category to stimulate investment in small businesses.

While the rule indicates the CBLR would not be subject to the capital conservation buffer, this would remain a significant consideration for Qualifying Banks on accepting of the new framework, notably those organized under Subchapter S rules, which comprise over one-third of Qualifying Banks. The reduced limit of 8 percent would allow greater flexibility for such Qualifying Banks that, again would maintain self-determined capital buffers to allow for adequate capital while maintaining the ability to meet the needs of their shareholders.

Considerations for Bankers' Bank of the West and Other Qualifying Correspondent Banks

There are two specific items that apply to bankers' banks and other qualifying correspondent service providers ("correspondent banks") that should be considered.

Treatment of pass-through reserve account balances

Pass-through Reserve account balances, included in total assets on Schedule RC (Balance Sheet; Cash and Balances Due From Depository Institutions), are double-counted by both correspondent banks and their respondent financial institutions. The respondent financial institution owns these funds, with the correspondent bank only acting as an agent in performing this valuable service to its respondent financial institutions. Further, pass-through reserve balances are excluded from total assets on Schedule RC-O (Other Data for Deposit Insurance and FICO Assessments).

Bankers' Bank of the West asks the Agencies to consider allowing a deduction for pass-through reserve balances held with the Federal Reserve Bank from the denominator of the CBLR calculation (Average Total Consolidated Assets). Such a deduction for correspondent banks will allow this calculation to more closely align the capital required based upon the risk of the assets held and will not unduly discourage correspondent banks from assisting their respondent financial institutions with holding adequate reserve balances with the Federal Reserve Bank.

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[1] "Regulatory Capital Rule: Capital Simplification for Qualifying Community Banking Organizations," Federal Register, https://www.federalregister.gov/documents/2019/02/08/2018-27002/regulatory-capital-rule-capital-simplification-for-qualifying-community-banking-organizations

- Board of Governors of the Federal Reserve System (Docket No. R–1638);
- Federal Deposit Insurance Corporation (Docket ID OCC–2018–0040);
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Access to liquidity for community banking organizations

Broader adoption of the CBLR would have a positive impact on market liquidity for community banking organizations. Community banking organizations have long utilized correspondent banks as agents for selling excess, overnight funds into the Federal Funds market. These Federal Funds were diversified across multiple upstream sources to reduce the risk exposure and were risk-weighted at 20 percent of capital. Correspondent banks could then also access the pool of Federal Funds and bring a portion on-balance sheet as a source of funding and liquidity for their respondent financial institutions to borrow from.

As part of the Emergency Economic Stabilization Act of 2008[2], Congress moved up the start date on authorizing the Federal Reserve Bank to begin paying interest on reserves held against certain types of deposit liabilities stemming from the Financial Services Regulatory Relief Act of 2006, thereby allowing the creation of the excess balance accounts (EBA)[3] at the Federal Reserve Bank. Federal Funds sold to the EBA are risk-weighted at zero percent of capital. As such, many community banking organizations have directed their Federal Funds balances to the EBA through their correspondent bank agent because the yield was not enough to account for the additional risk-weighting required.

By achieving wider adoption of the CBLR, Qualifying Banks could more freely access the broader Federal Funds market, often receiving a higher yield while diversifying the risk, without the implications against their capital ratios. The resulting benefit being, while aggregate market liquidity may not change, more funds would be available to correspondent banks to remain a source of liquidity for respondent financial institutions in need.

Conclusion

The Responders appreciate and support the efforts by the Legislature and Agencies to provide appropriate regulatory relief to community banking organizations. However, we believe that the CBLR minimum should be reduced to 8 percent to encourage greater adoption by Qualifying Banks, utilize Tier 1 capital for the numerator, provide for changes to accounting standards that may impact the ratio without any changes to the capital of Qualifying Banks, and insure the optionality within the CBLR for Qualifying Banks from the view of a regulatory oversight. The Responders also agree that the Agencies should create a means for the limit to not pertain to only those community banking organizations by increasing, indexing, or other means to allow for banks to grow while maintaining their community bank identities. The Agencies should also consider eliminating the capital conservation buffer, providing greater flexibility to Subchapter S banks while simultaneously allowing for complete access to the intended regulatory relief. Finally, there are considerations for correspondent banks that provide support and services to community banking organizations that should be considered with the final rule that will have a positive impact for their own adoption of the framework and ability to remain a source of liquidity for their respondent customers.

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[2] "Why did the Federal Reserve start paying interest on reserve balances held on deposit at the Fed?," Federal Reserve Bank of San Francisco, Education dated March 2013, http://www.frbsf.org/education/publications/doctor-econ/2013/march/federal-reserve-interest-balances-reserves

[3] Federal Reserve Bank Services, Excess Balance Account, https://www.frbservices.org/central-bank/reserves-central/excess-balance-account.html

Bankers' Bank of the West and the signatories to this comment letter appreciate the opportunity to share our thoughts and would be happy to discuss our comments in further detail.

Sincerely,

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[additional Signatories to this Comment Letter follow]

- Board of Governors of the Federal Reserve System (Docket No. R–1638);
- Federal Deposit Insurance Corporation (Docket ID OCC–2018–0040);
- Office of the Comptroller of the Currency (Docket ID OCC–2018–0040)

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