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OVERSIGHT OF BASEL III: IMPACT OF PROPOSED CAPITAL RULES

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE OVERSIGHT OF BASEL III

NOVEMBER 14, 2012

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C O N T E N T S

WEDNESDAY, NOVEMBER 14, 2012

WITNESSES

Additional Material Supplied for the Record

OVERSIGHT OF BASEL III: IMPACT OF PROPOSED CAPITAL RULES

WEDNESDAY, NOVEMBER 14, 2012

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 2:35 p.m., in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. I call this hearing to order.

After the financial crisis, Congress passed Wall Street Reform into law and asked our regulators to strengthen the financial sector by enhancing capital standards and prudential supervision. In addition, Federal banking agencies negotiated the Basel III accords, an agreement with other Nations' banking agencies. The proposed capital rules under discussion today implement that agreement. These are complex rules, and today we will hear from the experts at the Fed, OCC, and FDIC about the important goals they hope to accomplish with these proposed rules, as well as their potential impact.

Since the rules were proposed in June, Members of this Committee have heard a number of concerns about these rulemakings from former Federal regulators, current State regulators, industry participants, and academics. These concerns are documented in over 2,000 comment letters submitted by a wide range of stakeholders, including community banks and insurance companies.

While most agree the higher levels of capital are appropriate, the details of how to improve bank capital will have a broad impact and must be closely examined.

Specifically, with respect to community banks, I appreciate that your agencies have undertaken a number of efforts to explain the proposed rules to community banks, including issuing a capital estimation tool for banks to evaluate how the proposed rules will impact them. However, I am concerned that the proposed risk weights could have an adverse impact on small banks' ability and willingness to offer mortgages, especially in rural areas. I look forward to hearing more today about how the risk weights were determined for mortgages, securitizations, and mortgage servicing rights, and what kind of impact these rules might have on our housing market.

I also want to hear more about the proposed treatment of "accumulated other comprehensive income." At a time where interest rates cannot get much lower, we should pay particular attention to how new rules could make interest rate management more difficult, especially for smaller banks.

In addition, I am concerned by the treatment of the business of insurance in the proposed rules. Before moving forward with applying these rules to insurance companies, the banking agencies should take additional time to work with State insurance regulators, the Federal Insurance Office, and the independent insurance expert on the Financial Stability Oversight Council to better understand the insurance accounting framework and risk-based capital model currently used. This feedback should then be used to develop a capital framework that is more suitable for financial institutions engaged in the traditional business of insurance and give these companies appropriate time to implement the new framework.

A strong capital base is a key component of a resilient financial system. This was a major lesson of the financial crisis in 2008, and your agencies are to be commended in your efforts to steadily recapitalize the U.S. banking system and establish new standards. But while capital can serve as an important loss-absorbing buffer, capital alone will not prevent financial firms from failing and potentially threatening the broader financial stability. It is important that capital standards are well calibrated with other supervisory requirements, including new rules mandated by the Wall Street Reform Act. I look forward to hearing how each of your agencies is coordinating the ongoing rulemakings to ensure all of the pieces fit together.

I believe we share the same goal of strong and harmonized capital rules to promote financial stability, but before moving forward, it is important to understand how the regulators have considered, and will continue to consider, the concerns being raised. I encourage your agencies to take the appropriate amount of time needed to get these rules right.

Last, I want to applaud you all for the steps your agencies took last week to provide clarity on the Basel III rules' effective date. This was well in advance of the previously announced January 1, 2013, effective date, and I believe the announcement was very useful to those companies working to comply with these rules.

With that, I will turn to Ranking Member Shelby.

STATEMENT OF SENATOR RICHARD C. SHELBY

Senator SHELBY. Thank you, Mr. Chairman. Thank you very much for calling this hearing at this time. I think it is very, very important.

Today, as the Chairman has pointed out, the Committee will hear from the Federal Reserve, the OCC, and the FDIC about their proposed rules to implement the Basel III international accord. The primary goal of Basel III is to strengthen bank capital requirements. I think this is a worthy goal as strong capital requirements are essential for a safe and sound banking system and also to protect against taxpayer-funded bailouts.

Unfortunately, one of the clear lessons of the financial crisis is that bank regulators set capital requirements too low. In their proposals, the agencies themselves admit that when the crisis came, and I will quote, "the amount of high-quality capital held by banks globally was insufficient to absorb losses." We know this on this Committee. And as a result, taxpayers were called upon to bail out our banks, and our economy suffered its worst crisis since the Great Depression.

In light of this recent history, I support the agencies' goal of enhancing capital levels to protect American taxpayers from having to bail out banks down the road. Yet given the failure of bank regulators to set appropriate capital levels before the crisis, I cannot help but doubt the regulators' ability to set them correctly after the crisis. But there is hope.

Accordingly, I believe this Committee must rigorously, Mr. Chairman, review the agencies' proposals to ensure that the goal of Basel III is actually achieved. We should not, I think, simply rely on the agencies' assurances that their proposed rules will leave our banks properly capitalized. We have been down that road before. Instead, the agencies I hope would demonstrate to this Committee and to the public that their proposed rules are supported by proper data and rigorous economic analysis.

Regrettably, the agencies have so far not provided sufficient data and analysis of their proposals. That is why weeks ago I wrote to the agencies asking them to publicly released detailed estimates of how capital levels will change for U.S. banks under Basel III, how the agencies determine that those levels will leave the U.S. banking system well capitalized, and what will be the compliance cost. All that is important. These were basic questions that should be publicly answered before this rulemaking proceeds.

I do not believe that it will surprise anyone to learn that the agencies finally responded, Mr. Chairman, to my letter yesterday, right on the eve of this hearing. Unfortunately, their response relies largely on studies by the Basel Committee which use data only from the very largest banks. For example, one key study included data from only 13 U.S. banks. In addition, the Basel Committee's quantitative impact study aggregates country results. It does not specifically show how Basel III will impact the U.S., which we are interested in first and foremost here.

Even more troubling, the agencies state that they believe Basel III is appropriate based on the losses experienced by U.S. banks, but they do not up to now provide data to support this conclusion. You must do that.

It is time, I think, that our banking regulators stop outsourcing their economic analysis to the Basel Committee and start doing their own work. They need to determine, I believe, how Basel III will impact our diverse and unique banking system and the overall U.S. economy. They also need, I believe, to end their cloistered approach to rulemaking.

First, the public has the right to know the consequences of adopting Basel III, including how it will impact the stability of the U.S. banking system, economic growth in the U.S., and the ability of American consumers to obtain loans. The public's right to know, I believe, is even more pronounced given the agencies' failure to proper set capital requirements before the crisis. Moreover, there are growing doubts about Basel III's model-based approach to setting capital requirements. We should know what it is. You should be able to defend it.

Many commentators and even some regulators are concerned that the Basel III models are too complex and inaccurate to be relied upon. If the agencies want the public to have confidence—and that is very important—in Basel III, they need to make their case publicly, and this is a good place to start.

Finally, by omitting key data and analysis from this important rulemaking, the agencies are also undermining the ability of Congress through this Committee to hold the agencies accountable. The public depends on Congress to conduct oversight and to ensure that the agencies do their jobs effectively. Without more information, it is impossible to determine if the proposed rules will actually set capital requirements at the appropriate levels. Congress cannot, I believe, effectively engage in oversight right here if we do not know what goes on behind closed doors at the agencies.

It is my hope that the witnesses today can provide, at least to start, a more thorough and data-based explanation for their Basel III rule proposals. Both Congress and the public deserve a far better explanation than they have been given so far. I hope this will be a new day.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Shelby.

Are there any other Members who wish to make a brief opening statement?

[No response.]

Chairman JOHNSON. Thank you all. I want to remind my colleagues that the record will be open for the next 7 days for opening statements and any other materials you would like to submit. Now I will briefly introduce our witnesses.

Mr. Michael Gibson is the Director of the Division of Banking Supervision and Regulation at the Board of Governors of the Federal Reserve System.

Mr. John Lyons is the Chief National Bank Examiner at the Office of the Comptroller of the Currency.

Mr. George French is the Deputy Director of Policy in the Division of Risk Management Supervision at the Federal Deposit Insurance Corporation.

I ask our witnesses to limit their testimony to 5 minutes. Your full statements will be submitted for the record.

Mr. Gibson, you may proceed with your testimony.

STATEMENT OF MICHAEL S. GIBSON, DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. GIBSON. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on the proposed interagency changes to the regulatory capital framework for U.S. banking organizations.

The recent financial crisis revealed that too many U.S. banking organizations were not holding enough capital to absorb losses during periods of severe stress. In addition, some instruments that counted as capital were not able to absorb losses as expected. In short, the crisis showed us that banks were too highly leveraged. In response, the banking agencies' capital proposal would increase both the quantity and quality of capital held by banking organizations of all sizes.

Another lesson from the crisis was that the largest banking organizations were the most severely impacted. As a result, many items in the agencies' proposal and in other regulatory reforms are appropriately focused on larger banking firms and would not apply to community banking organizations.

We have assessed the impact of these proposed changes on banking organizations and the broader financial system. These analyses found that the stronger capital standards in our proposal would significantly lower the probability of banking crises and their associated economic losses, while having only a modest negative effect on gross domestic product and the cost of credit. The modest negative effects would be mitigated by the extensive transition periods provided in our proposal.

Our impact analysis also showed that the vast majority of U.S. banking organizations, including approximately 90 percent of community banking organizations, would not be required to raise additional capital because they already meet the proposed higher minimum requirements on a fully phased-in basis.

Community banking organizations play a vital role in the U.S. financial system. They can provide relationship-based lending in their local communities in a way that larger institutions would find difficult to duplicate. In developing the proposal, the agencies sought to strike the right balance between safety and soundness concerns and the regulatory burden associated with implementation, including the impact on community banking. We also conducted extensive industry outreach across the country, and we provided a tool to help smaller organizations estimate their capital levels under the proposal. As we consider the large volume of comments submitted by the public, the Federal Reserve will remain sensitive to concerns expressed by community banking organizations.

Community banking organizations are particularly concerned about the proposed treatments of unrealized gains and losses on securities, otherwise known as AOCI, and residential mortgage exposures. They believe that elements of our proposal do not adequately take into account the community banking business model and that some aspects would have potential disproportionate effects on their organizations. We will be mindful of these comments when we consider potential changes to the proposal, and we will work to appropriately balance the benefits of a revised capital framework against its costs.

The proposal would apply consolidated capital requirements to all assets owned by a depository institution holding company and its subsidiaries, including assets held by insurance companies. By treating all assets equally, the proposal would eliminate incentives to engage in regulatory capital arbitrage across different subsidiaries of the holding company.

The proposal is also consistent with the Collins Amendment in Section 171 of the Dodd-Frank Act, which requires that bank capital requirements be a floor for depository institution holding company requirements. Depository institution holding companies with insurance activities have raised concerns that the proposed regulatory capital requirements are not suitable for the insurance business model. The Federal Reserve takes these comments seriously and will consider them carefully in determining how to appropriately apply regulatory capital requirements to depository institution holding companies with significant insurance activities.

Thank you for the opportunity to describe the Federal Reserve's efforts to reform the regulatory capital framework for U.S. banking organizations, and I will be happy to answer any questions you have for me.

Chairman JOHNSON. Thank you, Mr. Gibson.

Mr. Lyons, you may proceed.

STATEMENT OF JOHN C. LYONS, CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

Mr. LYONS. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, I appreciate the opportunity to discuss the three proposed capital rules issued by the Federal banking agencies and their potential impact on the industry. We have received extensive comments on the proposals from banks of all sizes. In response to concerns raised by commenters, we announced last week that we will delay the January 1st effective date. We are especially mindful of the concerns that community bankers had raised about the potential burden and the impact these rules could have on their institutions.

Our goal is simple: to improve the safety and soundness of our Nation's banking system by ensuring that all banks of all sizes have sufficient capital to weather adverse conditions and unforeseen losses. Strong capital plays a vital role in promoting financial stability and moderating downturns by facilitate banks' capacity to lend.

During the recent cycle, the banks that were best able to meet the credit needs of their customers and communities were those with strong capital bases. This underscores the principle that higher capital standards that apply to all banks are essential to the financial strength of the industry and our Nation's economy.

Capital rules also need to reflect risks appropriately, and so under the proposal, riskier loans, such as certain types of nontraditional mortgages, would require more capital. We believe the proposals reinforce key objectives of the Dodd-Frank Act, specifically promoting financial stability and requiring higher capital for riskier firms and activities.

The June rulemaking package consists of three Notices of Proposed Rulemakings (NPR). Each NPR calibrates requirements to the size and riskiness of institutions so that larger banks will hold more capital and meet stricter standards than smaller ones. These are not one-size-fits-all requirements.

The first proposal introduces a new measure for regulatory capital called Common Equity Tier 1 and two new capital buffers—a capital conservation buffer that would apply to all banks, and a countercyclical buffer that would apply only to the largest institutions. For community banks, this would result in a Common Equity Tier 1 requirement of 7 percent of risk-weighted assets. For large, internationally active banks, this requirement could be as high as

13 percent when combined with a SIFI surcharge that is being considered internationally.

The second proposal, the Standardized Approach NPR, would modify certain risk weighting so that riskier loans and activities require more capital. Here, too, distinctions are made between small and large banks as certain provisions of the NPR, such as those related to securitization and credit risk mitigation, would have little or no application to most community banks.

The third proposal, the Advanced Approaches NPR, applies only to the largest internationally active institutions and does not affect community banks. To reduce possible adverse effects, especially for community banks that have less access to market sources of capital, the proposals include a lengthy transition period.

Our preliminary assessment is that many community banks hold capital well above the existing and the proposed regulatory minimums. Nevertheless, we took steps to maximize opportunities for community bankers to learn about and to comment on the proposals. These steps included short summaries aimed at community banks, extensive outreach with community bankers, and a tool to help them assess the impact of their proposals. While we have received comments on many issues, three overarching concerns have been raised:

First, many have cited the complexity of the rules. Community bankers in particular have questioned whether proposals should apply to them.

Second, many have raised concerns about including unrealized losses and gains and available-for-sale debt securities and regulatory capital and volatility that could result in capital levels and other limits tied to regulatory capital such as lending limits.

Third, bankers have expressed concerns about the recordkeeping burdens resulting from the proposed rules, the proposed use of loan-to-value measures for residential mortgages, and the higher risk weights that would be assigned to balloon residential mortgages.

As we consider these issues, we will continue to look for ways to reduce burden and complexity while maintaining our key objectives of raising the quantity and quality of capital and matching capital to risk. These enhancements will lead to a stronger, more stable financial system.

I appreciate your interest in this matter and would be happy to answer your questions.

Chairman JOHNSON. Thank you, Mr. Lyons.

Mr. French, you may proceed.

STATEMENT OF GEORGE FRENCH, DEPUTY DIRECTOR, POLICY, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

Mr. FRENCH. Thank you. Chairman Johnson, Ranking Member Shelby, and Members of the Committee, good afternoon. I appreciate the opportunity to testify on behalf of the FDIC about these proposed regulatory capital rules. My statement will focus on the two Notices of Proposed Rulemaking that pertain to community banks and some of the comments we have received.

One of these NPRs deals with the Basel III capital reforms. The core elements of Basel III would strengthen the quality of bank capital and increase its required level. These are basic concepts of capital adequacy that are relevant for any bank, and the Basel III NPR would apply them to all insured banks.

The Basel III reforms also include a number of complex provisions targeted at large, internationally active banks. We have proposed to apply these only to the largest banks, so these large banks would need to comply with the basic changes to the definition and level of capital that are proposed for all banks and also with additional standards that address the unique risks they face. The Basel III NPR also preserves the fundamental role of the U.S. leverage ratio. The FDIC strongly supports the introduction of the leverage ratio in the Basel framework as a transparent and objective measure of capital adequacy.

The second NPR that is relevant for community banks is the Standardized Approach NPR. It proposes a number of changes to the way banks compute risk-weighted assets and removes references to credit ratings consistent with the Dodd-Frank Act. I want to clarify that the changes to risk-weighted assets in the Standardized Approach NPR are separate and distinct from the international Basel III reform package.

The FDIC has devoted significant efforts to outreach and technical assistance to help community banks understand how these proposals may affect them. We have received more than 1,500 comments at last count, and many of these comments express concern that the proposals will negatively affect community banks' ability to serve the credit needs of their local communities. As the primary Federal regulator of the majority of community banks, the FDIC takes these comments very seriously.

In the last 5 years, we have seen over 460 insured banks fail and many hundreds more in problem bank status. This painful episode has imposed significant costs on our national and local economies and illustrates the importance of banks having a strong capital base so that they can continue to lend in their communities, even during periods of economic adversity.

Many commenters do acknowledge the importance of strong bank capital, but they also have concerns about specific aspects of the proposals, their complexity, or the totality of the potential effects. Among the more frequently mentioned specific issues are the residential mortgage rules in the Standardized Approach NPR and their interaction with other Dodd-Frank mortgage rules.

In the Basel III NPR, many commenters have focused on the proposed treatment of available-for-sale debt securities and many others on the phase-out of the preexisting trust preferred securities of smaller organizations.

Careful review of these and other comments is a critically important part of our process that gives us a better understanding of the potential unintended consequences and costs of the proposals. It is important to note that we have not reached decisions on any of these matters. These are proposed rules, not final rules, and we anticipate making changes in response to comments.

The basic purpose of the Basel III framework is to strengthen the long-term quality and quantity of the capital base of the U.S. banking system. In light of the recent financial crisis, that would appear to be an appropriate and important goal. However, that goal should be achieved in a way that is responsive to the concerns expressed by community banks about the potential for unintended consequences.

I would be happy to respond to your questions.

Chairman JOHNSON. Thank you for your testimony.

We will now begin asking questions of our witnesses. Would the clerk please put 5 minutes on the clock for each Member?

Mr. Gibson, last week, Governor Duke said, "Before we issue final capital rules, we will do everything possible to address the concerns that have been expressed by community banks and still achieve the goal of having strong levels of high-quality capital built up over a reasonable and realistic transitional period in banks of all sizes, including community banks."

How exactly do you plan to address the concerns expressed by community banks and others while maintaining strong levels of capital?

Mr. GIBSON. We believe that the vast majority of community banks already meet the higher level of capital that is proposed in the proposal, and our impact analysis has shown that to be the case. We have received a lot of comments from community banks on many aspects of the proposal, but mostly those comments are not aimed at the level of capital but at other aspects of the proposal. As I mentioned in my testimony, the treatment of unrealized gains and losses on securities, the proposed risk weights for residential mortgages, and various other things have been the focus of community bank comments.

We will definitely consider those comments as we move forward on a final rule, and we think that the fact that community banks already have a strong capital base makes them well positioned to meet the higher requirements. And as Governor Duke mentioned in her comment, allowing a longer transition period is another way of easing the burden, including the costs of implementation for new IT systems and other implementation costs that community banks have also expressed concerns about. So we definitely will take a look at that as we move forward.

Chairman JOHNSON. Mr. French, what impact will the current proposals have on the ability of community banks to offer balloon and second mortgages, especially in rural areas like we have in South Dakota? Also, will the current proposal make it more difficult for community banks to manage interest rate risk?

Mr. FRENCH. Mr. Chairman, we have heard about both of these issues many times from our community banks in face-to-face meetings. We had a good discussion of these just last week at our Community Bank Advisory Committee.

With regard to balloon loans, you know, we have heard the comment that many rural banks offer these loans. They are simple structures that the banks understand and have been making successfully for many years. So the question is whether, by trying to capture some of the more risky practices that we saw in the crisis, we are inappropriately sweeping these loans up in the proposed rule. And based on the comments, the commenters are very concerned about the impact this will have on these banks and the local communities. We take those concerns very seriously, and it is one of the issues we are focused on as we review the comments.

And with regard to AOCI, we have heard, again, many concerns about the volatility of regulatory capital that could come to pass as interest rates change, and the effect on managing things like legal lending limits, regulatory capital, capital planning, and also interest rate risk, because banks may feel forced to put more of their securities, their long-term securities, into the held-to-maturity bucket so that they will not face these fluctuations. That could limit their flexibility, to some extent, in addressing these changes in interest rates.

So this is, once again, an area we have heard a tremendous amount of comments from virtually every bank that we have spoken to, and we are studying the comments closely and deciding how to proceed with our fellow regulators.

Chairman JOHNSON. Mr. Lyons, should the capital rules alone fix all that went wrong in the financial crisis? Can more capital prevent all future financial crises? If not, what role should capital rules play and what role should other Wall Street reform rules play in mitigating future crises? Are you coordinating these rulemakings within and between the agencies to make sure the rules are complementary and not duplicative?

Mr. LYONS. Mr. Chairman, capital is important, although we do not believe it is the sole solution. We have coupled that with regulation. And we believe strong supervision is a process that should be in place as well. So we really look at it as three legs—capital buffers and liquidity buffers as well, coupled with regulation, that we are discussing today, the proposals, the capital proposals, as well as strong supervision.

Chairman JOHNSON. Mr. Gibson, what steps have you taken or will you take in consultation with insurance experts at the State and Federal level to better understand the differences between insurance companies and banks to ensure that the capital requirements in Basel III are well calibrated for the business of insurance?

Mr. GIBSON. Congress has required us to set consolidated capital requirements for bank holding companies and savings and loan holding companies, including those that choose to own an insurance company, and our goal has been to set strong capital requirements for both the quality and quantity of capital. We have been consulting with a wide range of insurance experts since we got this responsibility as a result of the Dodd-Frank Act, and our responsibility for savings and loan holding companies began last year. Our supervisors have been responsible and have been supervising savings and loan holding companies, including those with insurance operations, since last year, and they have been working with the State insurance regulators, as they do that supervision.

So far we have been learning a lot from insurance experts. Of course, the Federal Reserve has supervised insurance operations of bank holding companies for a long time, so we had a base of expertise to build on. We have received a lot of comments from insurance industry experts on many aspects of this proposal and we definitely intend to consider those comments carefully as we move forward.

Chairman JOHNSON. And, last, Mr. Lyons, with all the concerns that have been expressed, what time next year do you expect to issue a final rule? And how much time will you give companies to begin complying with the new requirements?

Mr. LYONS. Senator, it is a complex rule. We acknowledge that. In respect of that, we extended the comment period, and we have extended the effective date. We have, as George indicated earlier, over 1,500 comments that we have received. We are going to review each one of those, each and every one, and we will take those into consideration when we work on a final proposal and move forward.

Chairman JOHNSON. Senator Shelby.

Senator SHELBY. Thank you again, Mr. Chairman.

My basic question to all three of you, and I will quote: "The Bank of England Governor, Mervyn King"—and you are familiar with him, and a lot of us have a lot of respect for him—"and several other prominent economists in the world have said that the Basel III capital standards are insufficient to prevent another crisis."

Do you disagree or do you agree? And if so, why? We will start with you, sir, Mr. Gibson.

Mr. GIBSON. We feel that our proposal to raise the quality and quantity of bank capital is one of the most important pieces of the regulatory reform agenda.

Senator SHELBY. I agree with that.

Mr. GIBSON. Not by itself the complete agenda but one of the most important pieces, because we saw that capital leading into the crisis was too low.

Senator SHELBY. What about liquidity, too? Is that very important at the right time with capital?

Mr. GIBSON. Yes, we agree that liquidity reform is also an important piece of the reform agenda.

Senator SHELBY. Mr. Lyons.

Mr. LYONS. I would agree with what Michael has said, that capital and liquidity are both important, and we have surrounded the proposal here with—the Fed has prudential heightened standards that they are going to implement, and the FDIC will have resolution and living wills under Title 2. So we supplemented the regulation with what we think is stronger supervisory goals as well.

Senator SHELBY. Mr. French.

Mr. FRENCH. Senator, we agree that strong capital is an important check on excessive leverage in the system, and it is a vital shock absorber for losses that come along.

Senator SHELBY. That is what it is for, is it not?

Mr. FRENCH. That is correct. So we believe that this proposal is a significant strengthening of our current rules.

Senator SHELBY. So all three of you believe that the capital requirements of Basel III, if implemented properly, will be sufficient? At least we hope so, right? Is that fair? Nobody knows, but that is what you believe, right?

Mr. FRENCH. It provides substantial additional comfort compared to what we have now.

Senator SHELBY. OK. Mr. Gibson, let me ask you this question, if I can: Traditionally, insurance companies have been regulated at the State level. The proposed Basel III rules will apply to financial holding companies that own insurers. In devising capital requirements for holding companies that own insurance businesses, how much did the Fed rely on State insurance capital requirements, if they did? And explain how the Fed is coordinating its oversight of financial holding companies that own insurers with State insurance regulators who are the primary regulators?

Mr. GIBSON. Our supervision and regulation of savings and loan holding companies that have insurance operations is limited to the holding company level.

Senator SHELBY. And how many would that be, roughly?

Mr. GIBSON. There are a couple dozen of those.

Senator SHELBY. OK.

Mr. GIBSON. There are, of course, thousands of insurance companies in the U.S., and all insurance companies are subject to State-based regulation at the level of the insurance operating company. What we have the authority to do is for the holding company to set consolidated capital requirements and to consolidate its supervision.

With respect to working with State insurance regulators, our supervisors are looking at the holding company risks, and they work closely with the State insurance regulators who are focused on the risks in the insurance business.

Senator SHELBY. Let me pose this to all of you: The FDIC Director, Thomas Hoenig, recently gave a speech when he stated, and I will quote: "The poor record of Basel I, II, and II.5 is that of a system fundamentally flawed. Basel III is a continuation of these efforts, but with more complexity."

I have already quoted the Bank of England Governor. I also understand the Bank of England Executive Director of Financial Stability, Andrew Haldane, gave a speech and restated that the Basel framework "has spawned startling degrees of complexity and an over-reliance on probably unreliable models"—which is always dangerous.

My question to all three: Is the Basel framework too complex to really work? And will you know? And what testing did you do or will you do to determine the accuracy of the Basel III models? What did those tests show? Because I think we need to know. You have got a new regime here. We want it to work. Will it work? We do not know yet. It has not been tested. Mr. Gibson?

Mr. GIBSON. One aspect of our capital proposal is that, in addition to a risk-based capital requirement, we also have a leveraged capital requirement which is based on a simpler measure of capital to assets.

Senator SHELBY. Explain that as compared to the risk-based.

Mr. GIBSON. The risk-based applies——

Senator SHELBY. The leverage-based.

Mr. GIBSON. The leverage-based, it just takes the amount of assets on your balance sheet as the denominator, with no risk weighting or models involved. We feel that by having both of those, it is more effective at having strong capital than just one by itself, because one by itself could be gamed or arbitraged. By having the risk-based requirement, which is more complicated, in combination with the leverage ratio, you get some protection against that gaming by banks.

Senator SHELBY. Mr. Lyons.

Mr. LYONS. Senator, I will address your impact analysis. We did do an impact analysis similar to the Fed, but different. We did come up with a similar conclusion that most of the banks, the vast majority of banks will hold capital well above the required minimums. And we will do further analysis as we go through. We asked the commenters for what they have determined based on the estimator tool that we provided them, what type of impact it would be to them as well. So we will take that into consideration as we move forward.

Senator SHELBY. Mr. French.

Mr. FRENCH. I do want to say that the FDIC as an institution has long supported simple and objective capital standards.

Senator SHELBY. And they have worked, too, have they not?

Mr. FRENCH. We believe so. And we have always supported the leverage ratio and pushed hard to have simple floors under the risk-based requirements. In fact, there is a Basel Committee subgroup that is looking at ways to simplify these rules going forward, and we actually chair that group. So we——

Senator SHELBY. Will you share that data with this Committee, you know, what you are doing and how you are doing it and why?

Mr. FRENCH. Yes, we will. In terms of whether this will work, we are satisfied that, in terms of the overall level and the direction of this proposal, it is a substantive and meaningful strengthening of our capital system. We have to deal, of course, with all the specific comments about the specific aspects and the complexity.

Senator SHELBY. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Reed.

Senator REED. Well, thank you, Mr. Chairman. I want to follow up on Senator Shelby's questions, but also note that Senator Shelby was just as astute when Basel II was before the Committee, and through his efforts and Senator Dodd's efforts, Basel II was not embraced as enthusiastically here as in Europe, and when the crisis came, we were in a little bit better position, so thank you.

Senator SHELBY. Two big skeptics right here.

Senator REED. Well, you are a big skeptic; I am a half-size skeptic. He is a very big skeptic.

Let me ask a basic question, Mr. Gibson, and that is, what legal obligation do we have to follow Basel III? It seems a very simpleminded question, but for the record, please.

Mr. GIBSON. We do not have any legal obligation. It is not a treaty. But the member countries of the Basel Committee agree that having a global level playing field is important and holding banks in all the Basel Committee countries to high standards is important, and if we agree on what those standards are, we'll have an easier time doing that.

Senator REED. OK. So that we can shape to a degree our response to the Basel III concept, as you are doing right now, but also there is sort of a quid pro quo. If we are not stringent and we are not thoughtful about it, then we cannot expect the same process from other major financial countries.

Mr. GIBSON. That is right. We do tailor the Basel Committee agreements to our local U.S. circumstances, and we are allowed to do that within the boundaries that are set up by the Basel Committee.

Senator REED. One of the flaws with Basel II was that there was a great deal of reliance on internal risk models, that banks were essentially grading themselves on their capital. Is that still prevalent in the Basel III proposals?

Mr. GIBSON. The risk-weighting scheme in Basel II is maintained in Basel III. The change that is coming in Basel III is higher quantity and quality of capital requirements.

One thing that we are doing in the Basel Committee is a study across Basel Committee countries of how the risk weights are actually put into practice, and that is one of the Basel Committee's major initiatives for 2012 and is currently being worked on. We hope to learn from that process how each country is doing in terms of its banks' implementing the standards in a consistent way because, as you say, that is very important for the standards to work.

Senator REED. Indeed, but one of the problems which I think we mentioned with Basel II was that banks were—they were categorized, but they were the ones who were essentially evaluating their capital status. The regulators, of course, come in and review that. Is that still prevalent in Basel III? Is that still going to be the case?

Mr. GIBSON. Yes, that aspect of Basel has not changed.

Senator REED. Thank you very much.

One of the other points that was made—and I am just reinforcing again a point that Senator Shelby made—Mr. French, you talked about and Mr. Gibson responded also about the importance of the leverage ratio as well as the risk-asset ratio. And that is something that we have had in the United States, but this is a new aspect for Basel III for the whole community. Is that correct?

Mr. FRENCH. It is new in the Basel framework. We have had it in the U.S. really since the early 1980s, and then formally in the early 1990s. But it is an important step for the Basel Committee. I think it reflects their recognition from the crisis that many of the models really did need some objective constraints underneath them.

Senator REED. And let me ask you another question, which comes to some of the comments I have heard, particularly from community banks, and that goes to—and you mentioned it, Mr. French, that now instead of being able to rely upon a rating by a credit rating agency, there has to be essentially an analysis by the institution of the creditworthiness of the value of the asset on the book or the liability. Is that one of the issues of complexity that is being raised by community banks?

Mr. FRENCH. To some extent, yes. There are certain aspects that have not changed and, in fact, important aspects. If the bank holds a Treasury or an agency mortgage-backed security or whatever, it is going to keep doing what it has always done, which is use a 20-percent risk weight. If it does have a private label mortgage-backed or structured type of product, it is going to have to assess the structure of the securitization and apply a formula that would set capital based on the seniority of the tranche.

So there is some concern about that. I would say, however, that a number of the servicer reports and vendors are starting to put out information that the banks can apply pretty easily.

Senator REED. Thank you very much.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Corker.

Senator CORKER. Thank you, sir, and I thank each of you for being here to testify. You know, we have read through the proposals and looked specifically at the sovereign debt issue, and you can almost imagine a lot of folks, heads of States in Basel sipping champagne and thinking about a way to create a mechanism where the banks around the world are there to create money, loan them money through all the prolific ways that all of us have right now.

I am fascinated that sovereigns have a zero weighting, period, unless they are in default and it goes from zero to 150. So that would mean that our great thinkers around the world have decided that, for instance, today they would encourage U.S. banks to hold Spanish debt and have a zero risk weighting. I would just like for you all to explain to me how we have succumbed to a situation where all sovereign debt has a risk weighting of zero, especially during these times and what we are watching happen around the world.

Mr. LYONS. Senator, I will try to answer that. I do believe sovereign ratings—we do apply the OECD rating to those institutions, so there is a rating that is assigned to them. I would have to double-check and get back to you on the rate. You are saying it is a zero rate or 150. I am thinking there may be something in between there based on the rating of the sovereign, but I would have to double-check for you.

Senator CORKER. I do not think that is the case. Would one of the other two of you want to respond to that?

Mr. FRENCH. I think you characterized it fairly. For practical purposes, most of the countries would be zero until default. Theoretically, there would be some other countries that have a rating that would not get them zero, but they are few and far between for practical purposes. I think you raise clearly a very important point, and I think my only observation might be, for practical purposes here in the U.S., many of those obligations are going to be held in trading accounts of large banks where these proposals are irrelevant. They are going to be holding capital against market risk for those things. You know, if we had had the ability to use credit ratings, we might have been able to apply those. We were not allowed to do that by Dodd-Frank. So we have, you know, these minds sitting around the table, and we have to figure out how is the U.S. going to assign grades to different countries. And it is a challenge, so we acknowledge the issue.

Senator CORKER. I understand that these may well be in trading accounts, but I guess as people are looking at capital and they are trying to create a way of having return, and they know they can buy Spanish debt or some other debt of a sovereign and get a much greater yield, and you guys are not going to ping them on it, then you are basically encouraging them to buy risky sovereigns. It just makes no sense to me. And it is my understanding it was the Europeans that pressed us hard to move into this regime, and I am just wondering why we did not push back, especially since they are basically using their banking system to fund all the problems that they are having right now.

I mean, this seems to me something that would have just jumped out with alarms and we would have said this makes no sense and we are not going to be a part of this.

Mr. FRENCH. You raise very good points. Again, here in the U.S., I think if we actually had a bank that was applying zero risk weights, we would probably be on them from the supervisory perspective. There would be probably securities depreciation in their account if they were certain countries, and we would——

Senator CORKER. So they really could not rely upon the Basel. You are saying that if they actually were an international type institution and they were relying on Basel and following those rules, you would come at them a different way and say, well, no, you really cannot do that?

Mr. FRENCH. I think that for practical purposes, it is, again, the trading accounts of large banks. I do not think our smaller banks in the U.S. are for the most part buying these. That is my understanding. But I certainly take your points about——

Mr. GIBSON. I would just add that in our most recent stress test, we did impose a special look at exposures to a European stress event that did look at potential losses on those types of securities. So there are other tools besides regulatory capital rules to make sure that banks do not have excessive concentrations in sovereign debt.

Senator CORKER. I have two more questions, and I really would just make a comment on the second one, and then ask a third and try to be very brief. The complexity issue is fascinating. I noticed with the mortgage issues you all have got this grid with eight boxes, and you grade mortgages, and I actually thank you for doing that and appreciate it, and I hope we sync that up with the QM and QRM, other issues that are not part of Basel that are coming down the road.

But on credit card debt and auto debt and corporate debt, you do not do that. I just find that fascinating, that what you did, you spent, it sounds like, you know, months and months and months grading different mortgages, which I think we would all agree would be a good idea—subprime would be very different than prime with low debt ratios, but you do not do that on auto, you do not do that on corporate, you do not do that on credit. I just find it fascinating because each of them have those same complexities. If one of you would just answer why, then I will move to my last question and stop.

Mr. GIBSON. I would say that the risk weights that you are describing are the ones in the standardized approach, and it is difficult to come up with a standardized simple way to risk-weight corporate loans. But for the most advanced largest banks that are on the more complicated approaches, they would be required to do a more sophisticated analysis of corporate and other exposures.

Senator CORKER. OK. And then the countercyclical. I know Senator Warner, my friend from Virginia, we spent a lot of time a couple of years ago looking at how we can put in place something that is countercyclical. I actually think it is a novel idea that you guys have come up with this countercyclical buffer. No offense to you, but it seems that regulators always sort of are having fun when things are great and then they over-regulate on the downside and create self-fulfilling prophecies both ways.

I am just curious as to how we are going to have the wisdom to do this. I kind of like the idea, but, for instance, we have a pretty dovish Fed right now that does not want to create any panic. The Fed is probably the entity that would be doing this. Would they be willing to signal to folks that there is excessive debt out there? And would that create some kind of negativity in the marketplace, especially during a time like right now? Are you going to do it with algorithms, or is somebody just going to wake up one day and say, gosh, we have got excessive debt out there, and now all of a sudden everybody has a 2.5 percent charge?

I am just curious as to how you think that is going to work.

Mr. GIBSON. We are not in the situation of using the countercyclical buffer yet, so we have not completely spelled out the ways that we would do that. We would look at a variety of data indicators to try to get a sense of credit growth in the economy and whether there is excessive leverage and excessive credit growth. And then, you are right, it would be a tough call to actually turn on the countercyclical capital buffer. We have agreed that that is part of what the Basel Committee wants every country to be doing, and the burden will be on us to actually do it when the time comes. We are still pretty far from the point in the cycle where we will have to do that, but we are looking ahead and trying to think about how we would do that, what data we would look at, and so on.

Senator CORKER. Well, we look forward to greater input, and I thank you for the time, Mr. Chairman.

Chairman JOHNSON. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman, and I want to thank all of you. I think we were all struggling with you to figure out how we get this right as well as with some level of simplicity as capital markets get more and more complex. I want to follow up on a couple items my friend Senator Corker raised.

First of all, how do we make sure—just as I think you pressed the point about sovereign debt, on one level it is good that there will be other regulatory tools that would be available if banks were purchasing this debt and it was still zero weighted. But if we are thinking about this in the international context, how do we make sure that we are not still at a competitive disadvantage as American banks versus other banks that may not have that same level of scrutiny?

Mr. GIBSON. Generally, I would say that we gain a competitive advantage by having strong capital and strong regulation in place. So the fact that we might be tougher on our banks, for example, through the stress test regime, at least currently that seems to be perceived as a strength in the market that U.S. banks have that strong regulation. We definitely worry about level playing field considerations, and as I mentioned earlier, the Basel Committee is spending more effort now looking at how countries are implementing regulations in different jurisdictions, which they did not used to spend very much time on. We think that is important to follow up on, but generally, we would argue that stronger regulation is a strength.

Senator WARNER. Well, and the flip of that or kind of the converse of that is—and the Chairman has already raised this, and Senator Toomey and I put a letter together that I think the majority of our colleagues signed that said—and I think you all have responded in certain ways to make sure that we protect and not have a single one-size-fits-all for all our institutions. We are clearly unique in terms of the number of community-based banks, and I would like you to comment on, within these Basel negotiations, is America's voice being heard another about making sure there is not a one-size-fits all? And then, two, while we have talked about these capital standards ranging from 6 to 13, it is also based upon their SIFI designation. You know, are we also making sure that the kind of unique aspect of our regional banks are getting their voices heard?

Mr. GIBSON. The first point I would make in response is that the Basel agreements only apply to internationally active banks, so in the U.S. we are only committed to strictly apply the Basel standards to the largest internationally active banks.

Senator WARNER. But as we know, what oftentimes happens with regulators is something that is legally applied for a big bank up here, by default becomes kind of best practice standards and trickles down then oftentimes into very small institutions that cannot deal with all of this additional regulatory burden.

Mr. GIBSON. Sure, and we are resisting that in our proposal because we have proposed different things, in some aspects, for community banks than for large banks. We are definitely trying to implement regulatory reform in a way that minimizes the burden on community banks. That is a key priority for us because they do, as you say, play a critical role in the financial system and in their local communities.

Senator WARNER. And comment on regional banks here in terms of how they will fit among that continuum as well?

Mr. GIBSON. We draw a line at $250 billion in assets or $10 billion of foreign exposure, and that is the line above which we say——

Senator WARNER. It is either in or out.

Mr. GIBSON. You are in or out, we strictly apply Basel standards above that line.

Senator WARNER. A couple more questions I want to get to. One is—Senator Corker has left, but we did spend a lot of time about this notion of countercyclical, and we think it makes sense. Again, I have to say personally figuring out what is that trigger is a challenge. But I guess the other question I would have is even if we get that trigger right, if we think again from the standpoint of regional community-based banks, are we willing to drill down below a national level? Because we may very well have a roaring economy or a sinking economy at the national level, but a region that is doing much better. Think back to the 1990s in terms of some of the challenges that were faced in the Southwest and then, conversely, when that region roars. How do we make sure—and I am not being critical here because getting it right and then getting it right down at a lower level, but are you thinking if we get countercyclical, can we take it down one level lower to a regional base?

Mr. GIBSON. We have only proposed applying the countercyclical buffer from Basel to the large, internationally active banks in this proposal, and we have asked for comment on that, and we have gotten some comments that suggest we should apply it more widely than that. We are going to consider those comments as we go forward.

Senator WARNER. I think that if it ends up floating into best practices, we need to consider, obviously, plus with a large economy, but lots of regional economies that may or may not track national data.

Mr. GIBSON. Right, and that is challenging to apply a national capital standard against regional shocks.

Senator WARNER. And the only thing—and, again, my time is up, and I will just put this—maybe you can comment later because I do not want to impose on other time. But, you know, we urged you to make sure we look at the insurance business, but as we think about those assets and think about some of those assets that are held on a much longer time horizon than banks are, trying to get that right as well is going to be a challenge, and I hope we can visit on it.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Toomey.

Senator TOOMEY. Thanks, Mr. Chairman, and thanks, gentlemen, for being with us today. I, too, would like to follow up a little bit with the train of thought that Senator Corker was pursuing.

You know, when you think about some of the things that have been happening recently in the context of, specifically, I am referring to massive deficits, there is a long history, of course, of examples of the use by Governments of financial repression to help fund their own irresponsible fiscal policy. I would argue that the explicit exemption of U.S. Treasurys from the Volcker Rule is an example of financial repression in the United States. And when I hear that we have pressure from the Europeans to put zero capital weight into sovereign debt that intuitively to most Americans sure as heck does not sound like it is anything close to risk free, why should we be confident that there is not politically motivated financial repression creeping into this regulatory regime?

Mr. FRENCH. I will start. I think that from my experience, at least in the U.S. rulemaking process, we have a lot of very smart people on the staff who are trying to come up with proposals that would be an appropriate way to deal with sovereigns, and facing a number of constraints. One is that the U.S. is not allowed to use an external ratings-based approach by statute, and then, you know, when you put out the different ideas on the table, they all seem to be a challenge in one way or another to implement or pose issues.

My impression is not that there is some external constraint or influence on the process. It is really more of, frankly, a technical challenge, and this was the way that it came out, and we recognize fully and embrace the concern that you point out that, from a risk-based capital standpoint, it is not zero. But, again, as a practical matter, many of these are dealt with in trading portfolios in our banks and in other ways.

So I am not disputing the concern about getting the risk wrong in this instance, but——

Senator TOOMEY. It just seems an extraordinary coincidence that something so counterintuitive to suggest that some of the most troubled economies of Europe could have a zero risk weighting, at the same time when it is very convenient for there to be incentives for banks to hold this debt strikes me as a little troubling.

Let me ask another question. We have heard a lot of discussion about the complexity of this, and one of the things that I am concerned about is the cost of compliance. Do we know what it is going to cost the average American bank to comply with this? Say a regional bank—actually, a better example would be a small community bank, a $1 billion bank. What will it cost to comply, to figure out, evaluate this rule? This rule is 900-some-odd pages. Is that right? Do we know what that cost would be?

Mr. FRENCH. Each of us did some required statutory analysis of the cost issue, and I can speak to the FDIC's analysis. We looked at the cost of both the Standardized Approach Notice and the Basel III Notice. The costs in the area of the Standardized Approach were probably the most pronounced, in our estimation, and included the cost of implementing the mortgage provisions, gathering the data, some estimate for the cost of doing the securitization framework. And I think it came out to—you know, I think we concluded that for purposes of the statutory criteria, it will have a significant effect on a large number of small banks that it would. And so it was——

Senator TOOMEY. That it would what?

Mr. FRENCH. That it would have a significant cost, and that conclusion was based on a criteria of whether the cost would exceed in the first year more than 2.5 percent of noninterest expense or more than 5 percent of annual salary and bonus.

So based on the estimates that we did, we concluded it would have that cost effect. We asked for comment as part of the NPR on that analysis, and we are now getting comments that shed, I think, a great deal of additional light on the compliance costs, and those are some of the things that we have to address now as we proceed.

Senator TOOMEY. Well, one of the things that really concerns me is that it is very likely to be very significant compliance costs for institutions that nobody has ever suggested are systemically significant and why we would, you know, force this cost on these banks in that context. I hope that you will seriously reconsider this.

The last question I had is: I know that you have announced that the original planned effective date of January 1 is not going to be the date. What sort of date should the regulated firms expect to have a final rule that that will be effective?

Mr. LYONS. Senator, as I said during my testimony and questions from Chairman Johnson, we received over 1,500 comments. We are reviewing each comment. It will take time, and we have extended the implementation date because of the number of comments we received. And we will need time to go through those. I hesitate to give you an exact date, but I guarantee you we are working hard and diligently to come out with a proposal as soon as possible.

Senator TOOMEY. OK. Thanks, Mr. Chairman.

Chairman JOHNSON. Senator Bennet.

Senator BENNET. Thank you, Mr. Chairman, and I would like to pick up right where Senator Toomey was leaving off in his second to the last question. These conversations can sound so clinical in Washington, but at home, what I am seeing among my community banks is, on the one hand, deep—well, first of all, the observation that Senator Toomey made that nobody has said that the community banks are in any way responsible for the cataclysm that we went through, and that is true. There were some, as Mr. French said, that failed—that is certainly true—but did not create systemic risk in the way the large institutions did. And the observation of the panel today that community banks already have a high capital base. So from their perspective, the question is what problem are you trying to solve here. And they are worried that they are catching it from two ends. One is that the capital requirements will diminish the opportunity for equity investors to earn a return on investment and their investment in community banks. And I do not need to tell you how difficult capital formation already is for these guys. And, on the other hand, the cost of compliance, which I appreciate very much, Mr. French, your response that it appears based on your review that the costs will be significant and you are going to have to revisit that.

My worry, talking to folks in Colorado, is that they really worry that they are going to be driven out of business, and that this is going to lead to a consolidation that is going to mean many fewer community banks serving our rural areas in particular in the State. And I wonder, first of all—you know, if the market is driving consolidation, that is one thing. But if it is because of the regulatory burden that is solving a problem that does not actually exist in the community banks, that may not be the greatest answer.

So I guess what I am looking for is some assurance that you really have heard the comments that you have reflected back to us today and that we are actually going to significantly change these rules to make sure that we are not driving that kind of consolidation.

Mr. FRENCH. Certainly, from the FDIC's perspective, I would say that our Chairman, our Acting Chairman Gruenberg, has been out in outreach meetings throughout the year. We have had meetings specifically on these notices with bankers around the country, many face-to-face meetings, and gotten a lot of letters. So, you know, as I said, we are the primary supervisor of the majority of community banks in this country, and we do not want to create a situation where the compliance costs make them uncompetitive or unable to serve their important roles in the local community.

So, you know, I think we are all in a position of looking at all these letters, looking at all the individual issues where bankers have raised concerns, and deciding how to proceed, and we take the concerns very seriously.

Senator BENNET. Mr. Gibson.

Mr. GIBSON. I would agree with that. We have heard a lot of comments from community banks, and especially on this issue of the costs of implementation. We are learning a lot from the comments about particular aspects of the proposal that may have a disproportionate impact there. And we are going to carefully look at that as we move forward.

Senator BENNET. And that is, I think, an important point, too, that their view is, whether it is well intentioned or not, it is having a disproportionate effect because they cannot spread those fixed costs over their institution in the same way that a larger institution is able to do it. That seems like a very reasonable concern to me. And I have, Mr. French, asked—because it is not of use to me in interacting with you when I get general complaints from people, too much regulation, too much this, too much—but when people can be specific and go to the trouble of being specific about it, I find it very helpful. I have asked my Colorado bankers to pull that information together, how many pages, how many lawyers, how much money are they going to spend, all that kind of stuff. And I would love the chance to share that with your director when we receive it in the hope that we can help inform the work.

Mr. FRENCH. We would be glad to do that.

Senator BENNET. OK. One last question, before I run out of time, on the European situation. I will ask Senator Warner's question in a slightly different way. What is your confidence that the European institutions actually are in a position to comply with Basel III? You talked about the competitive advantage that the stronger balance sheets have in the United States. How about our worry that the counterparts in Europe just are not ready to do this?

Mr. GIBSON. The European Union is at the same phase in the process as we are of proposing rules, having some draft rules out for comment but not yet final. So they are also not going to meet the January 1, 2013, implementation date, but one thing that is built into the Basel III agreement is a very long transition period out to 2019. We feel that is going to be sufficient to allow most banks to cope with the higher capital requirements that are coming.

Senator BENNET. I am out of time, but I will send you my last question.

Mr. Chairman, thank you very much.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman. Thank you, members of the panel, for being with us this long today.

I share the concerns of a number of Members of the Committee about insurance companies and wanted to say something about that and then ask a question about higher capital requirements.

Congress clearly intended for regulators to respect the State-based insurance system, regulatory system, when crafting capital rules. I believe that we provide the Fed with sufficient authority and flexibility under Dodd-Frank to do so. I appreciate you said you are taking seriously the concerns we have raised about insurance in carefully considering comments about this issue. My staff has asked for the Fed's opinion regarding your legal authority. I would hope in the interest of transparency you would provide us with that information, if you would. And I appreciate your working with us on that.

Mr. GIBSON. OK.

Senator BROWN. My colleagues have already pointed out that rules can be manipulated. In addition to being too easily gamed, I am concerned the current 3-percent Basel III leverage ratio or the 4-percent U.S. leverage ratio are simply much too low. Mr. Haldane of the Bank of England, Sheila Bair, Tom Hoenig, and Anat Admadi at Stanford say that the ideal leverage ratio should be somewhere—not 3 or 4 percent but somewhere between 2 and 5 times the current proposal.

Section 165 of Dodd-Frank requires the Fed to establish special enhanced rules for both risk-based capital and pure leverage for the biggest systemically important banks.

Will you consider establishing stronger leverage ratios than that provided in Basel III for the largest banks, the largest six or so banks, $800 billion to $2.2 trillion, $2.3 trillion, whatever the largest is now, either on an individual or group basis? Does that make sense to you?

Mr. GIBSON. What we have proposed under Section 165 for domestic banking organizations—we have already put that proposal out for comment, and we have received a lot of comments, including in the capital aspect of that. We are working through those comments, and I cannot prejudge where we will wind up with that, but we have heard the comments that you have mentioned calling for significantly higher capital. It is one of the comments we have received.

Senator BROWN. Can you tell me anything about your internal discussions about the inadequacy, if that is how you see it, of the 3 percent or 4 percent from Basel III or from us?

Mr. GIBSON. As I said before, we feel like having the leverage ratio in the U.S. was a valuable complement to the risk-based ratio, so I cannot really address your comment about the exact level of the leverage ratio that is the right one. We definitely found that having the leverage ratio prohibited some of the gaming of regulatory capital charges that took place elsewhere. We are very supportive of continuing with both the risk-based and the simple leverage ratio.

In terms of what the level of the leverage ratio should be, that is included in this proposal that we are discussing here. We have got a lot of comments on that, including the comments that you are mentioning, and we are going to review those carefully as we move forward.

Senator BROWN. Any thoughts, Mr. French or Mr. Lyons, on that?

Mr. FRENCH. I would only add that, as I said, I think the FDIC has had an institutional predisposition to fairly simple and objective capital standards, including the leverage ratio. So in terms of the level, we have not engaged at that in terms of the specifics, and, again, I think as Mr. Gibson said, it would not be appropriate for me to prejudge where we might come out on the level.

Senator BROWN. Mr. Lyons.

Mr. LYONS. I would only point out, Senator, that those are minimums, and the expectation typically is in a bank that they would be higher than the minimums. And we have, as Mike indicated, surrounded that with heightened prudential standards, so there are other aspects of supervision that we can employ to provide for additional capital in institutions.

Senator BROWN. OK. Thank you. Mr. French said that his proclivity is toward simpler rather than more complex. I am concerned Basel III allows the largest banks—and I mentioned six largest, but wherever you cut them off in terms of size—to use complex internal models to determine capital requirements for transactions that were some of the most troublesome during the crisis—collateralized debt obligations, over-the-counter derivatives, all of that. It makes it easier for the largest banks to game the system because of their complexities, to use their own models to make themselves look less risky than they, in fact—or at least I think they are. Meanwhile, small banks that are already better capitalized do not engage in these complex transactions and do not have a team of lawyers to help them comply in so many cases.

The Basel II modeling approach that we adopted relied on banks to calculate their own capital rules. How does this new framework, as you have proposed, reduce the ability of the biggest banks to use complexity and opacity to their advantage? I would like all three of you to answer that, but Mr. French especially.

Mr. FRENCH. Well, one aspect that we have not discussed here today which is important to mention is the requirements of Section 171 of the Dodd-Frank Act known as the Collins amendment, and that is an important and relevant provision for purposes of this discussion. Basically the requirement is that the large banks and any bank over a certain size would need to compute not only those Advanced Approach models-based capital requirements, but also the general capital requirements that any other bank would need to compute and hold to the higher of the two standards. So it basically is sort of a horizontal equity-type provision in the law that does have a significant effect in terms of constraining the potential benefits of those models.

Senator BROWN. Mr. Lyons, are you concerned about the big banks gaming the system to look like they are less risky?

Mr. LYONS. I think, as George indicated, the supplemental leverage ratio is based on average assets, so it does not involve models and risk-based. It is strictly on the average assets of the balance sheet as well as off-balance-sheet items as well. So in addition to a risk-based method, we have a balance sheet method as well. Couple that with supervision and recent—not recent but since the crisis, interagency guidance that we issued on modeled expectations of what banks should go through and the risk management they have around that, I think we supplemented the ratios with stronger supervision.

Mr. GIBSON. I would just add that a lot of the complexity in our capital rules and in these proposals is aimed at the complex activities of the largest banks. So sometimes complex activities require complicated analysis. However, that only applies to the banks that are engaged in those trading activities, and, in fact, Basel III raised the capital requirements or is in the process of raising the capital requirements on a lot of those activities precisely because of some of the concerns that you mentioned. So the complexity is really being put on the banks that have the capacity to deal with it. Community banks would not be subject to these requirements because they do not engage in those sorts of complex activities.

Senator BROWN. Well, thank you to each of you. I think many of us on this Committee are concerned about an outside examiner's ability to understand the huge number of transactions. The six biggest U.S. megabanks have some 14,000 combined subsidiaries. Someone calculate that to do the same audit at the largest banks as you do at—the same level of audit that you do at the community banks would take some 70,000 auditors. And, you know, the belief that these banks are—I am not asking for comment here, but the belief that these banks are too big—not just too big to fail but too big to manage and too big to regulate stays with us. And I think anything you can move toward coming out of Basel III that brings a simpler system that the banks cannot game is so very important.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you again to our witnesses for being here today. Your hard work on these complicated rulemakings is appreciated, especially as we all work to make our financial system more stable.

This hearing is adjourned.

[Whereupon, at 3:58 p.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follow:]

PREPARED STATEMENT OF CHAIRMAN TIM JOHNSON

After the financial crisis, Congress passed Wall Street Reform into law, and asked our regulators to strengthen the financial sector by enhancing capital standards and prudential supervision. In addition, Federal banking agencies negotiated the Basel III accords, an agreement with other Nations' banking agencies. The proposed capital rules under discussion today implement that agreement. These are complex rules, and today we will hear from the experts at the Fed, OCC, and FDIC about the important goals they hope to accomplish with these proposed rules, as well as their potential impact.

Since the rules were proposed in June, Members of this Committee have heard a number of concerns about these rulemakings from former Federal regulators, current State regulators, industry participants and academics. These concerns are documented in over 2,000 comment letters submitted by a wide range of stakeholders including community banks and insurance companies.

While most agree the higher levels of capital are appropriate, the details of how to improve bank capital will have a broad impact and must be closely examined.

Specifically, with respect to community banks, I appreciate that your agencies have undertaken a number of efforts to explain the proposed rules to community banks, including issuing a capital estimation tool for banks to evaluate how the proposed rules will impact them. However, I am concerned that the proposed risk weights could have an adverse impact on small banks' ability and willingness to offer mortgages, especially in rural areas. I look forward to hearing more today about how the risk weights were determined for mortgages, securitizations, and mortgage servicing rights, and what kind of impact these rules might have on our housing market.

I also want to hear more about the proposed treatment of "accumulated other comprehensive income." At a time where interest rates cannot get much lower, we should pay particular attention to how new rules could make interest rate management more difficult, especially for smaller banks.

In addition, I am concerned by the treatment of the business of insurance in the proposed rules. Before moving forward with applying these rules to insurance companies, the banking agencies should take additional time to work with State insurance regulators, the Federal Insurance Office, and the independent insurance expert on the Financial Stability Oversight Council to better understand the insurance accounting framework and risk-based capital model currently used. This feedback should then be used to develop a capital framework that is more suitable for financial institutions engaged in the traditional business of insurance, and give these companies appropriate time to implement the new framework.

A strong capital base is a key component of a resilient financial system. This was a major lesson of the financial crisis in 2008, and your agencies are to be commended in your efforts to steadily recapitalize the U.S. banking system and establish new standards. But while capital can serve as an important loss-absorbing buffer, capital alone will not prevent financial firms from failing and potentially threatening the broader financial stability. It is important that capital standards are well calibrated with other supervisory requirements, including new rules mandated by the Wall Street Reform Act. I look forward to hearing how each of your agencies is coordinating the ongoing rulemakings to ensure all of the pieces fit together.

I believe we share the same goal of strong and harmonized capital rules to promote financial stability, but before moving forward it is important to understand how the regulators have considered, and will continue to consider, the concerns being raised. I encourage your agencies to take the appropriate amount of time needed to get these rules right.

Last, I want to applaud you all for the steps your agencies took last week to provide clarity on the Basel III rules' effective date. This was well in advance of the previously announced January 1, 2013, effective date and I believe the announcement was very useful to those companies working to comply with these rules.

PREPARED STATEMENT OF SENATOR SHERROD BROWN

Thank you, Mr. Chairman, for holding this very important hearing, and thank you to the witnesses for their testimony.

We are here to discuss the U.S. implementation of three new proposed rules on capital and leverage.

Capital rules simply require banks to fund themselves with their own money—usually in the form of equity—instead of other people's money, borrowed from the markets, regulators, or U.S. taxpayers.

Prior to the financial crisis, financial institutions relied upon too much borrowed money and flawed models that used smoke and mirrors to make their investments appear riskless.

But they were not riskless. And when their assets declined by even the smallest amount, they were unable to pay their debts.

As a result, the taxpayers were forced to step in and cover Wall Street's risky bets.

I am encouraged that there is now broad, bipartisan agreement among the Members of this Committee that adequate bank capital is an essential tool for protecting the financial system.

Basel III is clearly an improvement over Wall Street's old way of doing business, but I question whether the new rules get it right.

First, are we properly defining and measuring capital?

Clearly there were shortcomings in the regulators' measurement of capital prior to the crisis.

At the height of the crisis, seemingly healthy institutions had respectable levels of regulatory capital.

According to the FDIC's Thomas Hoenig, in 2007, the 10 largest banks had average risk-based capital ratios of 11 percent. But their tangible equity ratios were about 2.8 percent.

As a result, markets lacked confidence in these institutions.

According to Federal Reserve Governor Dan Tarullo, this was because investors ignored the more exotic instruments that qualified as capital and instead looked at tangible equity.

This experience provides strong support for the view that we should focus on pure equity as a measure of a bank's health.

Second, are the levels sufficient to lessen the likelihood and severity of future crises?

The Bank of England's Andy Haldane estimates that global banks hold assets with average risk-weighting of 40 percent, meaning that the 10 percent risk-weighted Basel III ratio would amount to leverage or 25-to-1.

Were a megabank's assets to decline by 4 percent under that scenario, it would become insolvent.

A number of studies have shown that the optimal risk-weighted assets to capital ratios are considerably higher than those contained in Basel III.

Banks had considerably higher capital before the creation of the financial safety net.

So we know that the international 3 percent leverage ratio is much too low—prior its failure, Bear Stearns had leverage of 33 to one.

The U.S. benchmark of 4 percent is also too low—Haldane estimates that institutions would have needed a minimum 7 percent leverage to have survived the financial crisis.

My legislation, the SAFE Banking Act calls for 10 percent tangible equity to total assets, not adjusted for risk and including those held off-balance sheet.

Third, have we created a system of complex rules on top of complex banks that are excessively complex and opaque?

The six largest banks currently have a combined 14,420 subsidiaries.

Haldane has estimated that an average large bank would have to conduct more than 200 million calculations in order to determine their regulatory capital under the Basel II framework.

Several million scenarios could arise from a large bank's trading book alone.

The evidence suggests that these complex and highly calibrated measurements do not work.

Haldane has found that simple measures of equity and leverage actually have predictive value that is ten times greater than that of complex risk-weighted asset measurements.

And finally, are we too focused on community banks or traditional insurance companies, and not enough on Wall Street megabanks?

According to Dr. Hoenig, in 2009, the 20 largest financial institutions on average funded themselves with a mix of 3.5 percent equity capital, as compared to an equity capital ratio of 6 percent held by the second tier of institutions.

These megabanks can use more leverage because implicit Government support, where the market assumes that the Government will step in to prevent them from failing, provides subsidies and it puts true community banks—those with less than $10 billion in assets—at a disadvantage.

These incentives can be counteracted by requiring megabanks to increase their capital buffers.

I agree with Governor Tarullo that the proposed surcharges for the largest institutions are at the low end of the scale.

We should do more to impose costs that will discourage banks from becoming "too big to fail."

This will benefit taxpayers, and it will benefit the community banks that compete with unfairly subsidized megabanks.

These are all important questions, because we must ensure that Wall Street has a prudent amount of its own money to cover its losses.

Thank you, Mr. Chairman.

PREPARED STATEMENT OF MICHAEL S. GIBSON

DIRECTOR, DIVISION OF BANKING SUPERVISION AND REGULATION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

NOVEMBER 14, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify on the proposed interagency changes to the regulatory capital framework for U.S. banking organizations. In today's testimony, I will provide an overview of the proposed changes and the main themes arising from the public comment process, especially as they relate to community banking organizations and depository institution holding companies with insurance activities.

Overview of Proposed Changes

The recent financial crisis revealed that the amount of high-quality capital held by banking organizations in the United States was insufficient to absorb losses during periods of severe stress. The effects of having insufficient levels of capital were further magnified by the fact that some capital instruments did not absorb losses to the extent previously expected. While robust bank capital requirements alone cannot ensure the safety and soundness of the banking system, we believe they play a key role in protecting the banking system and financial stability more broadly.

As demonstrated during the recent financial crisis, banking organizations with strong capital positions are better equipped to absorb losses from unexpected sources. Furthermore, strong capital positions help to ensure that bank losses are borne by shareholders, rather than taxpayers. The June 2012 interagency proposal to amend the bank regulatory capital framework applies the lessons of the crisis, in part, by increasing the quantity and quality of capital held by banks.[1] For all banking organizations, the proposal would introduce a new common equity tier 1 capital requirement, raise existing minimum tier 1 capital requirements, and implement a capital conservation buffer to increase bank resiliency during times of stress. The proposal also updates and harmonizes the existing capital rules with a standardized approach for the calculation of risk-weighted assets, incorporating a more risk-sensitive treatment for certain asset classes to address weaknesses identified in the capital framework in recent years.

For large, internationally active organizations, the proposal would introduce a supplementary leverage ratio, a countercyclical capital buffer, and would effectively raise the capital requirement by updating aspects of the advanced approaches risk-based capital rule. These amendments, along with other recent regulatory capital enhancements, will require the large, systemically important banking organizations to hold significantly higher levels of capital relative to other institutions. Under the proposal, savings and loan holding companies would, for the first time, be subject to consolidated capital requirements, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). With this proposal, U.S. bank capital requirements would reflect international Basel III agreements reached by the Basel Committee on Banking Supervision as well as relevant domestic legislative provisions, including sections 171 and 939A of the Dodd-Frank Act.

In developing this proposal, the Federal Reserve sought to strike the right balance between safety and soundness concerns and the regulatory burden associated with implementation, including the impact on community banking. It is important to note that numerous items in this proposal, and in other recent regulatory reforms, are focused on larger institutions and would not be applicable to community banking organizations. These items include the countercyclical capital buffer, the supplementary leverage ratio, enhanced disclosure requirements, the advanced approaches

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[1] *See,* press release and proposal, *www.federalreserve.gov/newsevents/press/bcreg/20120612a.htm.*

risk-based capital framework, stress testing requirements, the systemically important financial institution capital surcharge, and market risk capital reforms.

Impact

The Federal Reserve has assessed the impact of the changes proposed by this rulemaking on banking organizations and the broader financial system through domestic analyses and through its participation in cost-benefit analyses performed by the Basel Committee on Banking Supervision. The Macroeconomic Assessment Group, a working group of the Basel Committee, found that among internationally active banks, the stronger capital standards proposed under Basel III would significantly lower the probability of banking crises and their associated economic losses, while having only a modest negative effect on gross domestic product and the cost of credit.[2] Furthermore, these modest negative effects can be mitigated by the phase in of the standards over time, which is why we have included extensive transition periods for several aspects of the proposal. The Federal Reserve believes that the benefits of the proposed changes, in terms of the reduction of risk to the U.S. financial system and to the broader economy, outweigh the compliance costs to the financial industry and any costs to the macroeconomy.

In developing the proposal, each of the Federal banking agencies prepared an impact analysis of the proposed requirements on banking organizations that currently meet the minimum regulatory capital requirements, based on each agency's own key assumptions using regulatory reporting data. The Federal Reserve's analysis and assumptions are included as an attachment to today's testimony.[3] The overall conclusion of these analyses was that the vast majority of banking organizations would not be required to raise additional capital because they already meet, on a fully phased-in basis, the proposed higher minimum requirements. In addition, approximately 90 percent of community banking organizations already have sufficient capital to meet or exceed the proposed buffer, thus avoiding restrictions on capital distributions and certain executive bonus payments. While many of the largest banking organizations do not already meet the proposed new minimums and the buffer on a fully phased-in basis, they are generally making steady progress toward meeting these standards before they are phased in. However, the Federal Reserve is mindful that other burdens exist for banks, such as systems changes and other compliance costs, which were outside the scope of our analysis.

Public Comments on the Proposed Changes

The Federal banking agencies released the proposed rulemaking in early June with an extended comment period ending on October 22, giving interested parties more than 4 months to comment on the proposal rather than the typical 2- or 3-month comment period. The agencies have received thousands of comment letters from the public, including banking organizations of all sizes, trade groups, academics, public interest advocates, and private individuals.[4] Agency staffs are reviewing these letters carefully and will continue to do so in the coming weeks. Comments include general views on the proposal, including concerns regarding overall complexity and burden, as well as suggestions for specific policy changes and technical modifications aimed at better conforming the proposal to market practices.

The most common specific areas of concern noted by the financial industry, regardless of institution size, relate to the proposed treatments of accumulated other comprehensive income, otherwise known as AOCI, and residential mortgage exposures. The proposed treatment of AOCI would require unrealized gains and losses on available-for-sale securities to flow through to regulatory capital as opposed to the current treatment, which neutralizes such effects. Commenters have expressed concern that this treatment would introduce capital volatility, due not only to credit risk but also to interest rate risk, and affect the composition of firms' securities holdings. The proposed treatment of AOCI is part of the Basel III Accord and is meant to better reflect an institution's actual loss-absorption capacity; however, we are analyzing commenters' concerns and will be assessing potential ways forward in this area as we finalize the rule.

In light of observed high loss rates for residential mortgages during the crisis, the agencies proposed a modified treatment aimed at better differentiating the risks of these exposures, which are generally assigned preferential risk weights under our

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[2] *See,* "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements" (August 2010), *www.bis.org/publ/othp10.pdf*; and "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements" (August 2010), *http://www.bis.org/publ/bcbs173.pdf.*

[3] *See,* Attachment A—"FRB Impact, Methodology, and Assumptions".

[4] *See,* comment letters, *www.federalreserve.gov/apps/foia/ViewComments.aspx?doc__id=R-1442&doc__ver=1.*

current approach. Commenters have expressed concern that the operational burden and compliance costs of the proposed methodology for risk weighting residential mortgage exposures and the higher risk weights for certain types of mortgage products will increase costs to consumers and reduce their access to mortgage credit. The Federal Reserve, along with the other Federal banking agencies, will take these and all comments received into consideration as we finalize the rule.

Community Banks

The Federal Reserve believes capital requirements that improve the quantity and quality of regulatory capital would benefit the resiliency of all banking organizations regardless of size. However, as we consider comments from industry participants and other interested parties regarding the proposed regulatory capital requirements, the Federal Reserve, along with the other Federal banking agencies, will remain sensitive to concerns expressed by community banking organizations. The Board recognizes the vital role that community banking organizations play in the U.S. financial system. Community bankers typically have deep roots in their communities, allowing them to gain insights on their local economies and to forge strong relationships with customers. As a result, they can provide relationship-based lending to small businesses, families, and others in their local communities in a manner that larger institutions would find difficult to duplicate.

When the agencies were developing these proposals, we recognized the need to carefully assess their impact on community banking organizations. While we conducted internal analysis to estimate the impact of the proposal (as discussed earlier), the Federal Reserve also recognized the importance of soliciting feedback directly from community banking organizations to understand more specifically the potential effects on their business activities. To facilitate review of the proposal, the agencies provided summaries of the requirements that were most relevant for community banking organizations, provided a tool to help smaller organizations estimate their capital levels under the proposal, and extended the comment period so that interested parties would have more time to assess the proposals and submit their comments. The Federal Reserve also engaged in substantial industry outreach to hear the views of community bankers and encourage submission of comments. For example, we held a series of "Ask the Fed" sessions aimed primarily at banking organizations supervised by the Federal Reserve that provided an overview of the proposals and gave bankers an opportunity to ask us questions. Following these sessions, which were attended by more than 3,000 bankers, we published a summary of answers to frequently asked questions in a new Federal Reserve publication for community bankers.[5] Throughout the comment process, Board members and staff also met with various industry associations to clarify and discuss aspects of the proposal.

Through outreach efforts and as part of the comment process, community banking organizations have expressed concerns about particular elements of the proposed requirements, indicating that they do not adequately take into account the community banking business model and that some aspects would have potential disproportionate effects on their organizations. In particular, they have asserted that the proposed treatment of AOCI would have more of an impact on community banks because they have fewer available strategies to address the resultant capital volatility relative to larger institutions. In addition, they have expressed concern that the relatively higher risk weights assigned to certain mortgage products would penalize loan products that community banking organizations typically provide their customers. We will be mindful of these comments when considering potential refinements to the proposal and will work to appropriately balance the benefits of a revised capital framework against its costs. As we work toward finalizing the rule, we will seek to further tailor the requirements as appropriate for community banking organizations.

Insurance Holding Companies

The proposal would apply consolidated risk-based capital requirements that measure the credit and market risk of all assets owned by a depository institution holding company and its subsidiaries, including assets held by insurance companies. In addition, the proposal would capture the risk of insurance underwriting activities included in the consolidated holding company capital requirements by requiring deduction of the minimum regulatory capital requirement of the relevant State regulator for insurance companies in the consolidated group. Currently, capital requirements for insurance companies are imposed by State insurance laws on a legal enti-

[5] *See,* "Community Banking Connections: A Supervision and Regulation Publication" (Third Quarter, 2012), *www.communitybankingconnections.org/articles/2012/Q3/CBCQ32012.pdf.*

ty basis and there are no State-based, consolidated capital requirements that cover the subsidiaries and noninsurance affiliates of insurance companies.

The proposed capital requirements have been criticized by savings and loan holding companies that are not currently subject to consolidated capital requirements and that have significant insurance activities. Before mentioning some of the concerns raised by the industry, I would like to provide some background regarding the policy rationale for this proposal. The proposed application of consolidated capital requirements to savings and loan holding companies is consistent with the Board's long-standing practice of applying consolidated minimum capital requirements to bank holding companies, including those that control functionally regulated subsidiary insurance companies. Importantly, such an approach eliminates incentives to engage in capital arbitrage by booking individual exposures in the legal entity in which they receive the most favorable capital requirement.

The proposed requirements are also consistent with the Collins Amendment in section 171 of the Dodd-Frank Act, which requires that the agencies establish consolidated minimum risk-based and leverage requirements for depository institution holding companies (bank holding companies and savings and loan holding companies) that are no less than the generally applicable risk-based capital and leverage requirements that apply to insured depository institutions under the prompt corrective action framework. At the same time, the proposal included provisions assigning specific risk weights to assets typically held by insurance companies but not depository institutions, namely policy loans and nonguaranteed separate accounts. These provisions were designed to appropriately risk weight assets particular to the insurance industry while at the same time ensuring that the proposals complied with section 171 of the Dodd-Frank Act and fulfilled the policy goals for consistent consolidated capital requirements previously described.

Through the comment process, depository institution holding companies with insurance activities raised overarching concerns that the proposed regulatory capital requirements, which have primarily been developed for banking organizations, are not suitable for the insurance business model. In particular, they assert that the proposal does not appropriately recognize the longer-term nature of their liabilities and their practice of matching asset and liability maturities. They also assert that the proposal would disproportionately affect longer term assets held by many insurance companies, thus causing them to fundamentally alter their business strategy. These holding companies also have requested a longer transition period to implement consolidated capital requirements for the first time. Currently, those savings and loan holding companies that are also insurance companies report financial statements to State insurance regulators according to Statutory Accounting Principles and would have to begin reporting under the Generally Accepted Accounting Principles to comply with consolidated regulatory capital requirements, a change they assert would be unreasonably costly.

The Federal Reserve takes these comments seriously and will consider them carefully in determining how to appropriately apply regulatory capital requirements to depository institution holding companies with significant insurance activities.

Timeline

Given the breadth of the proposed changes, many industry participants have expressed general concern that they may be subject to a final regulatory capital rule on January 1, 2013, as contemplated in the proposals, and that this would not provide sufficient time to understand the rule or to make the necessary systems changes. Therefore, the agencies clarified on Friday that they do not expect to finalize the proposal by January 2013.[6] We are working as quickly as possible to evaluate comments and issue a final rule that would provide the industry with appropriate transition periods to come into compliance.

Thank you. I would be pleased to take your questions.

[6] *See,* "Agencies Provide Guidance on Regulatory Capital Rulemakings", *www.federalreserve.gov/newsevents/press/bcreg/20121109a.htm.*

Top-tier BHCs that meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)			
BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that meet 4% tier 1 minimum today	859	77	936
%	98%	99%	98%
Avg $ amount of tier 1 in excess of minimum ($000s)	$111,428	$10,479,898	
Avg multiple of tier 1 held / tier 1 required	3.8	3.6	

Proposed rule (Basel III)			
BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that meet 6% tier 1 minimum as proposed	810	74	884
%	92%	95%	93%
Average $ amount of tier 1 in excess of minimum ($000s)	$71,715	$5,658,259	
Average multiple of tier 1 held / tier 1 required	2.1	1.9	

Top-tier BHCs that do not meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)			
BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that do not meet 4% tier 1 minimum today	18	1	19
%	2%	1%	2%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$34,766	-$497,448	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$625,791	-$497,448	

Proposed rule (Basel III)			
BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Number of BHCs that do not meet 6% tier 1 minimum as proposed	67	4	71
%	8%	5%	7%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$32,716	-$688,217	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$2,191,942	-$2,752,868	

Proposed rule (Basel III) excluding those who fail tier 1 min today			
BHC total asset size	>= $500m and < $10b	>$10 b	Total
Total # top-tier BHCs	877	78	955
Tier 1			
Number of BHCs that do not meet 6% tier 1 minimum as proposed	49	3	52
% of total	6%	4%	5%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$17,124	-$309,260	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$839,087	-$927,781	
Common equity tier 1 (CET1)			
Number of BHCs that do not meet 4.5% CET1 minimum as proposed	54	1	55
% of total	6%	1%	6%
Average $ amount of CET1 4.5% shortfall of minimum ($000s)	-$15,355	-$21,888	
Aggregate $ amount of CET1 4.5% shortfall of minimum ($000s)	-$829,181	-$21,888	
Number of BHCs that do not meet 7% CET1 minimum as proposed	150	8	158
% of total	17%	10%	17%
Average $ amount of CET1 7% shortfall of minimum ($000s)	-$23,483	-$752,523	
Aggregate $ amount of CET1 7% shortfall of minimum ($000s)	-$3,522,450	-$6,020,186	

Banks that meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that meet 4% tier 1 minimum today	7,213	107	7,320
% of total	99%	100%	99%
Avg $ amount of tier 1 in excess of minimum ($000s)	$30,110	$6,055,069	
Avg multiple of tier 1 held / tier 1 required	5.7	4.1	

Proposed rule (Basel III)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that meet 6% tier 1 minimum as proposed	7,094	106	7,200
% of total	98%	99%	98%
Average $ amount of tier 1 in excess of minimum ($000s)	$24,184	$4,153,418	
Average multiple of tier 1 held / tier 1 required	3.7	2.4	

Banks that do not meet tier 1 minimums under the current and proposed rule
Data as of March 31, 2012

Current rules (Basel I)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that do not meet 4% tier 1 minimum today	56	0	56
% of total	1%	0%	1%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$2,344	$0	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$131,254	$0	

Proposed rule (Basel III)			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Number of banks that do not meet 6% tier 1 minimum as proposed	175	1	176
% of total	2%	1%	2%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$5,303	-$106,263	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$928,108	-$106,263	

Proposed rule (Basel III) excluding those who fail tier 1 min today			
Bank total asset size	< $10b	>=$10b	Total
Total # banks	7,269	107	7,376
Tier 1			
Number of banks that do not meet 6% tier 1 minimum as proposed	119	1	120
% of total	2%	1%	2%
Average $ amount of tier 1 shortfall of minimum ($000s)	-$4,273	-$106,263	
Aggregate $ amount of tier 1 shortfall of minimum ($000s)	-$508,437	-$106,263	
Common equity tier 1 (CET1)			
Number of banks that do not meet 4.5% CET1 minimum as proposed	59	0	59
% of total	1%	0%	1%
Average $ amount of CET1 4.5% shortfall of minimum ($000s)	-$6,694	$0	
Aggregate $ amount of CET1 4.5% shortfall of minimum ($000s)	-$394,934	$0	
Number of banks that do not meet 7% CET1 minimum as proposed	187	2	189
% of total	3%	2%	3%
Average $ amount of CET1 7% shortfall of minimum ($000s)	-$6,206	-$196,296	
Aggregate $ amount of CET1 7% shortfall of minimum ($000s)	-$1,160,524	-$392,592	

ATTACHMENT A

Impact Analysis Methodology for Basel 3 NPRs

- Staff conducted an analysis to assess the impact of the proposed changes to the definition of capital (Basel III NPR) and to risk-weighted assets (Standardized Approach NPR) for banks and top-tier bank holding companies using available data, as of March 31, 2012, from the commercial bank Call Reports and the holding company FR Y-9C reports. Because required data was not always available, staff made certain assumptions (listed below) to calculate the Basel III requirements.

Definition of capital (numerator of risk-based capital ratios)

- With respect to the regulatory deductions from capital, staff made assumptions regarding the amount of:
  - outstanding DTAs subject to full deduction and the amount subject to the threshold deductions;
  - investments in the capital of unconsolidated financial institutions subject to the threshold deductions; &
  - common equity tier 1 and tier 1 minority interest based on outstanding Class A minority interest.

Standardized approach risk-weighted assets (denominator of risk-based capital ratios)

- To estimate Basel III risk-weighted assets, staff used line items from the Call Report and Y-9C to estimate changes in the risk-weighted asset amount for residential mortgage exposures, high-volatility commercial real estate (HVCRE) exposures, past-due loans, and securitizations.
- The risk weight for HVCRE exposures (defined as construction, land development, and other land loans for this analysis; available on the regulatory reports) was increased from a risk-weight of 100% to 150%.
- Residential Mortgage Exposures
  - First-lien residential mortgage exposures as reported on the regulatory reports (currently risk weighted at 50%) were assumed to be category 1 exposures, while junior lien exposures, including home equity lines of credit, (currently risk-weighted at 100%) were assumed to be category 2 exposures.
  - To distribute residential mortgages across the proposed risk weights, which are based on LTV, an LTV distribution for firms' first and second lien mortgage portfolios was estimated using loan LTV data from industry databases (McDash and Corelogic) and then spread across the Category 1 risk weights (35% to 100%) and Category 2 risk weights (100% to 200%), as appropriate.
- Past-due loans (loans past due 90 days or more and nonaccrual loans, excluding residential mortgages and sovereign exposures), which currently are risk-weighted at 100%, were assigned to the 150% risk weight.
- For foreign sovereign exposures, used the public cross-border claims and the foreign-office claims on local residents in non-local currency from the FFIEC 009 report to find a distribution of foreign sovereign exposures by country, which was assumed to be representative across all institutions. Assigned risk weights by country: under Basel I, OECD countries received a zero percent risk weight, while all other countries received a 100% risk weight; under Basel III, assigned countries risk weights according to their CRC ratings. Applied country distribution, with associated risk weight, to foreign debt securities line items from the regulatory report.
- Securitization exposures
  - An interagency analysis was conducted using the simplified supervisory formula approach to calculate risk weights on tranches within 60 securitization transactions downloaded from an industry database (Intex) 15 deals each were selected for credit cards, autos, residential mortgages, and commercial mortgages.
  - To calculate average risk weights under Basel I, each tranche of the selected transactions was assigned a risk weight according to the general risk-based capital rules with certain assumptions. As a result, certain exposures were assigned risk weights according to the ratings-based approach, most mezzanine and junior positions were assumed to receive a 1,250% under the gross-up approach, and low-rated senior positions were assigned a 100% risk weight. To calculate average risk weights under Basel III, the SSFA was applied to each tranche of the selected transactions.
  - The current balance of each transaction was used to calculate a weighted average risk weight across each transaction type. These risk weights were then applied to each bank's value of summed items from the regulatory report for RMBS, CMBS, auto, and credit card.

ATTACHMENT A

I. Steps for estimating the numerator changes for the capital ratios under the Basel 3 proposal

Staff from an inter-agency work group used both qualitative measures (such as discussions with banks), as well as quantitative measures (such as QIS data) to create the assumptions used to estimate capital as proposed in the Basel 3 NPRs.

The assumptions include:

- 40% of a bank's deferred tax assets (DTAs) are used as a proxy for "carry-forward DTAs," which would be subject to full deduction
- 60% of DTAs are used as a proxy for "temporary differences DTAs," which would be subject to strict limits
- 80% of qualifying non-controlling (minority) interests in consolidated subsidiaries is used as a proxy for qualifying "common equity tier 1 minority interest"
- 20% of qualifying non-controlling (minority) interests in consolidated subsidiaries is used as a proxy for qualifying "tier 1 minority interest"
- 40% of investments in unconsolidated subsidiaries and associated companies is used as a proxy for "significant investments in unconsolidated financial institutions in the form of common stock"
- Regarding tier 1 deductions resulting from the corresponding deduction approach, trust preferred securities issued by financial institutions are used as a proxy for investments in the capital of unconsolidated financial institutions

1. Basel 3 Common equity tier 1 (CET1) calculation

The following items from the regulatory reports were used in the Basel 3 CET1 numerator calculations:

Item	Banks (Call Report)	BHCs (Y-9C)
Common stock	RCFD3230	BHCK3230
Surplus	RCFD3839	BHCK3240
Retained Earnings	RCFD3632	BHCK3247
AOCI	RCFDb530	BHCKb530
Other equity capital components	RCFDa130	BHCKa130
Qualifying non-controlling (minority) interests in consolidated subsidiaries	RCFDb589	BHCKG214
Goodwill	RCFDb590	BHCKb590
Cumulative change in fair value of all financial liabilities accounted for under a fair value option that is included in retained earnings and is attributable to changes in the bank's own creditworthiness	RCFDf264	BHCKf264
Purchased credit card relationships and nonmortgage servicing assets	RCFDb026	BHCKb026
Net deferred tax assets	RCFD2148	BHCK2148
Investments in unconsolidated subsidiaries and associated companies	RCFD2130	BHCK2130
Mortgage servicing assets	RCFDa590	BHCK6438

The Basel 3 CET1 base

The Basel 3 CET1 base used for the 10 and 15% threshold limitations described below is calculated by adding common stock, surplus, retained earnings, AOCI, other equity capital components, and 80% of qualifying non-controlling (minority) interests in consolidated subsidiaries (CET1 minority interest). Subtracted from that value is goodwill, the cumulative change in fair value of financial liabilities, the purchased credit card relationships and nonmortgage servicing assets, and the 40% of DTAs ("carry-forward DTAs").

The 10 and 15% threshold limitations on MSAs, DTAs, and significant investments in unconsolidated subsidiaries in the form of common stock

The 10% potential deduction for MSAs, "temporary differences DTAs" and significant investments in unconsolidated financial institutions in the form of common stock is calculated using the CET1 base described above.

The 15% limitation for MSAs, "temporary differences DTAs" and significant investments in unconsolidated financial institutions in the form of common stock is equal to 17.65% of the Basel 3 CET1 base, less the sum of the 10% deductions described above.

Basel 3 CET1 capital calculation

Basel 3 CET1 is equal to the Basel 3 CET1 base, less deductions resulting from the 10% limitations, less deductions resulting from the 15% limitation described above.

2. Basel 3 Tier 1 capital calculation

The following items from the regulatory reports were used in the Basel 3 tier 1 numerator calculations:

Item	Banks (Call Report)	BHCs (Y-9C)
Perpetual preferred stock and related surplus	RCFD3838	BHCK3283
Non-qualifying perpetual preferred stock	RCFDb588	BHCKb588
Qualifying non-controlling (minority) interests in consolidated subsidiaries	RCFDb589	BHCKG214
Trust preferred securities issued by financial institutions (HTM fair value from HC-B)	RCFDg349	BHCKg349
Trust preferred securities issued by financial institutions (AFS fair value from HC-B)	RCFDg351	BHCKg351
Trust preferred securities issued by financial institutions (consolidated from HC-D)	RCFDg299	BHCKg299

Basel 3 tier 1 capital calculation

Basel 3 tier 1 capital is estimated to be equal to the Basel 3 CET1 base plus perpetual preferred stock and related surplus, plus tier 1 minority interest, less non-qualifying perpetual preferred stock and less any amount of investments in the capital of unconsolidated financial institutions above the 10% threshold limitation.

2. Basel 3 Tier 2 and total capital calculation

The following items from the regulatory reports were used in the Basel 3 tier 2 and total capital numerator calculations:

Item	Banks (Call Report)	BHCs (Y-9C)
Qualifying subordinated debt and redeemable preferred stock	RCFD5306	BHCKg217
Cumulative perpetual preferred stock includible in Tier 2 capital	RCFDb593	BHCKg218
Allowance for loan and lease losses includible in Tier 2 capital	RCFD5310	BHCK5310
Qualifying restricted core elements (other than cumulative perpetual preferred stock)		BHCKg215
Unrealized gains on AFS equity securities includable in Tier 2 capital	RCFD2221	BHCK2221
Other Tier 2 capital components	RCFDb594	BHCKb594

Basel 3 tier 2 capital calculation

Basel 3 tier 2 is calculated by adding qualifying subordinated debt and redeemable preferred stock, cumulative perpetual preferred stock includible in tier 2 capital, allowance for loan and lease losses includible in tier 2 capital, unrealized gains on available-for-sale securities includable in tier 2 capital, other tier 2 capital components, and qualifying restricted core elements (other than cumulative perpetual preferred stock), which is the value of the trust-preferred securities that were removed from tier 1 capital.

Basel 3 total capital calculation

Basel 3 total capital is calculated by adding tier 1 and tier 2 capital as described above.

II. Steps for estimating the denominator changes for the capital ratios under the Basel 3 proposal (standardized approach)

To determine the impact of the changes to risk-weighted assets under the standardized approach, staff used existing risk-weighted assets (less numerator deductions), and then added the Basel III "impact" for the following categories: foreign sovereign exposures, foreign DI exposures, high volatility commercial real estate (HVCRE), past-due loans, residential mortgage exposures, and securitization exposures.

1. "Base" risk-weighted assets and risk-weighted asset impact by category

The "base" (reported) risk-weighted asset value for each bank was first adjusted to reflect any of the capital deductions described in part I (numerator changes). Staff then estimated a change in risk-weighted assets for each category (foreign sovereign exposures, foreign DI exposures, HVCRE, past-due loans, residential mortgage exposures, and securitization exposures) by pulling line items for each category, and comparing the risk-weighted exposure amount under Basel I versus under Basel III.

A. Foreign Sovereign Exposures.

1) Sum line items RCFD 1742, RCFD 1744, and RCFD 2081 for each bank, finding one value, "sovereign amount" per bank.

2) Sum the exposure amounts from 009 Report line items FCEX C916 and C919 for each country. Find the % by country by dividing total for country over total exposures for all countries for FCEX C916 and C919. Will have one % for each country. This "distribution" will be used for all banks and bank holding companies.

For this analysis:

- Removed countries where there were no exposure values
- Removed lines that were regions or sums of countries (ie only included individual country data)

3) Find appropriate risk weight under Basel I and Basel III per country as outlined below:

Basel I (baseline)
4) Exposures to OECD member countries receive a zero percent risk weight, while exposures to all other countries receive a risk weight of 100 percent. Multiply applicable risk weight (zero or 100) by exposure amount per country. Sum the amounts per country, per bank to find risk-weighted exposure amount by asset size group.

Basel III

CRC Ratings	Risk Weight
0-1	0%
2	20%
3	50%
4-6	100%
7	150%
No CRC	100%

4) Use CRC table to find appropriate risk weight per country. Multiply risk weight by the distribution percentage found in step 2; then multiply by exposure amount per bank.

B. Foreign DI Exposures.

1) Pull line RCFD B532 for each bank as "foreign DI amount."

2) Sum the exposure amounts from 009 Report line items FCEX C915 and C918 for each country. Find the % by country by dividing total for country over total exposures for all countries for FCEX C915 and C918. Will have one % for each country. This "distribution" will be used for all banks and bank holding companies.

3) Find appropriate risk weight under Basel I and Basel III per country as outlined below:

Basel I (baseline)
4) Foreign DI exposures to OECD member countries receive a 20 percent risk weight, while exposures to all other countries receive a risk weight of 100 percent. Multiply applicable risk weight (20 or 100) by exposure amount per country.

Basel III

4) Use CRC table below to find appropriate risk weight per country. Multiply risk weight by the distribution percentage found in step 2; then multiply by exposure amount per bank.

CRC of Sovereign Incorporation	Risk Weight (%)
0-1	20
2	50
3	100
4-7	150
No CRC	100

C. High Volatility Commercial Real Estate (HVCRE)

Steps for analysis:

1) Pull line item RCONf159 by bank as "HVCRE."

Basel I
2) HVCRE under Basel I is 100% risk-weighted.

Basel III
2) HVCRE under Basel III is 150% risk-weighted.

D. Past-due loans

Steps for analysis:

1) Sum line items: rcfdf171 rcfdf170 rcfd5461 rcfd5460 rcfd1256 rcfd1255 rcfd1253 rcfd1252 rconc229 rconc237 rconc230 rconc239 rcfdf167 rcfd1597 rcfd5391 rcfd5390 rcfd5382 rcfd5381 rcfd5379 rcfd5378 rcon3495 rcon3494 rconf183 rconf181 rconf180 rconf182 rcfnb574 rcfnb573 rcon5400 rcon5399 rcon3501 rcon3500 rcfd1583 rcfdk215 rcfdk214 rcfdk217 rcfdk218 rcfdb577 rcfdb576 rcfd3506 rcfd3507 rconf177 rconf175 rcfdf168 rconf176 rconf174) as "Past Due Loans" per bank.

Basel I
2) Past Due loans under Basel I are 100% risk-weighted.
Basel III

2) Past Due loans under Basel III are 150% risk-weighted.

E. Residential Mortgage Exposures.

Steps for analysis:

1) Pull line item RCON 5367 (first liens) per bank as "RCON 5367." Sum line items RCON 1797 and RCON 5368 (junior and revolving liens) for each bank as "RCON 1797+RCON 5368."

Basel I
2) Multiply "RCON 5367" by 50% (RW); multiply " RCON 1797 +RCON 5368" by 100% (RW). Sum these values by bank to find the risk-weighted exposure amount for residential mortgages.

Basel III
2) Distribute "RCON 5367" according to table and multiply that amount by appropriate risk weight, per the table. Sum the values by bank. Note for this analysis, used the original LTV category (per ALH). Distributions for Category 1 and Category 2 loans are based on analysis from Paul Calem (document titled "ltv distributions.txt").

Original LTV Category	80% of First liens are Category 1	Category 1 risk weight	20% of First liens are Category 2	Category 2 risk weight
<= 60	32.73	35%	4.02	100%
> 60 and <= 80	60.81	50%	18.04	100%
> 80 and <= 90	2.89	75%	26.44	100%
>90	3.58	100%	51.5	200%

3) Distribute "RCON 1797 +RCON 5368" according to table and multiply that amount by appropriate risk weight, per the table.

LTV Category	Percent of principal balance by category	Category 2 residential mortgage exposure risk weights
<= 60	22%	100%
> 60 and <= 80	40%	100%
> 80 and <= 90	24%	150%
> 90	14%	200%
Total	100%	

F. Securitization Exposures.

Approach: The New York RB and the Philadelphia RB provided a file of anonymized securitization data from large banking organizations across five product types (CLOs, non-agency RMBS, Credit Card, Auto, and CMBS) with the necessary data points including an external rating, attachment point and detachment points, and cumulative loss data. For each of these product types, risk weights were calculated for 25 securities under the Baseline and the SSFA. The average risk weights under the Baseline and the SSFA for these securities were used as a proxy to estimate the impact.

1. For each product type, provide the weighted average for the Baseline RW and the SSFA risk weight.

Type	Baseline Ave RW (Basel I treatment)	SSFA Ave RW (Basel III treatment)
Credit Cards	109%	170.4%
Autos	52%	67%
CMBS	164%	239.5%
RMBS*	365%	445%

*to find Basel 1 risk weight for RMBS, using interagency-supplied securitization data:

1) Used "current" cycle date data only
2) anything with a detachment point of 100 (senior) got 100% risk weight, all else got 1250% as "B1 risk weight"
3) used current bal to find a weight per transaction
4) multiplied weight by B1 risk weight; summed risk weights to find one weighted average risk weight

2. Baseline reporting line items:

Type	Baseline Call Report Line Items	Baseline BHC Line Items
Credit Cards	RCFD B838, RCFD B841	BHCK B838, BHCK B841
Autos	RCFD B846, RCFD B849	BHCK B846, BHCK B849
CMBS	RCFD K146 RCFD K149, RCFD K154, RCFD K157	BHCK K146, BHCK K149, BHCK K154, BHCK K157
RMBS	RCFD G308, RCFD G311, RCFD G320, RCFD G323	BHCK G308, BHCK G311, BHCK G320, BHCK G323,

3. For each product type, aggregate and average the Call Report line items and apply the Baseline (Basel 1) risk weights and SSFA risk weights (Basel 3).

3. Calculate impact and Basel III risk-weighted assets

For each category (foreign sovereign exposures, foreign DI exposures, HVCRE, past-due loans, residential mortgage exposures, and securitization exposures), multiplied the line items from the regulatory reports first by the risk weight for Basel I, which represented the risk-weighted assets under Basel I for that category. This step was replicated for Basel III by multiplying the line items from the regulatory reports by the risk weight for Basel III, which represented the risk-weighted assets under Basel III for that category.

The "impact" of Basel III was the Basel III amount per category less the Basel I amount per category, per bank, which represented the increase in risk-weighted assets for that category. The impact amount from each category was added to the "base risk-weighted assets" calculated in step 1 per bank. The sum of the base risk-weighted assets plus the impacts of each category represented the Basel III risk-weighted asset amount.

4. Additional Notes:

- This analysis was replicated for banks and bank holding companies.
- For the bank holding company analysis, used only top-tier BHCs with more than $500 million in total assets.
- Instances where tier 1, as reported in the Call Report or Y-9C was negative was left in the analysis, assuming that the reported figures were accurate.

PREPARED STATEMENT OF JOHN C. LYONS

CHIEF NATIONAL BANK EXAMINER, OFFICE OF THE COMPTROLLER OF THE CURRENCY

NOVEMBER 14, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for your invitation to testify.* I appreciate the opportunity to appear before you today to discuss the three proposed capital rules released by the Federal banking agencies (the Office of the Comptroller of the Currency (OCC), the Federal Reserve Board, and the Federal Deposit Insurance Corporation) in June, and in particular, the impact of those proposed rules on national banks and Federal savings associations and the stability of the U.S. financial system.

During the public comment period for these proposals that ended on October 22, 2012, the OCC and the other Federal banking agencies received approximately 1,500 comment letters from banks and Federal savings associations of all sizes. In light of the number of comments received and the important issues raised, the agencies announced last week that we do not expect to finalize the proposals by January 1, 2013. While we are still in the process of reading and assessing the comments, it appears that the most fundamental issues have been raised by small banks and Federal savings associations (collectively, community banks) who have raised concerns about the applicability of the standards to them. Large banks have raised some of the same concerns as the community banks in terms of specific provisions contained in the proposals as well as additional concerns that are more technical in nature. Since our comment review process is in early stages, there are some limitations on the views I can express to avoid prejudging the outcome of the rulemaking process.

We are committed to carefully considering all the comments we received; however, my testimony today will focus on some of the overarching concerns raised, and in particular, those raised by community bankers. In this regard, I want to assure you that we are very cognizant of the special role that smaller banks play in our communities and in providing financing of our country's small businesses and families.

It's important to start by noting that the key reason that we issued the proposals was to improve the safety and soundness of our Nation's banking system. Strong capital standards have played an important role in moderating downturns and positioning the banking system to serve as a catalyst for recovery by ensuring that financial institutions stand ready to lend throughout the economic cycle. Access to credit by businesses and consumers is critically important to promoting and achieving financial stability. The recent crisis demonstrated the consequences of having insufficient capital in the banking system of the U.S. and around the world.

The international Basel III agreements embraced many of the lessons learned during the crisis relating to regulatory capital. As members of the Basel Committee on Banking Supervision, the agencies worked to develop these enhanced capital standards, and the elements contained in the Basel III international framework are reflected in much of what we have proposed to apply in the U.S. As the OCC has previously testified, many of the key provisions and objectives of Basel III complement key capital provisions of the Dodd-Frank Act.[1] However, in developing the U.S. capital proposals, we did not adopt a "one-size fits all approach." We carefully evaluated each element of the Basel III framework and assessed to which banks it should be applied. In making these assessments, the agencies strove to calibrate the requirements to reflect the nature and complexity of the financial institutions involved. As a result, and consistent with the higher standards for larger banks required by section 165 of the Dodd-Frank Act, many of the provisions in the proposed rules are only for larger banks and those that engage in complex or risky activities; community banks with more basic balance sheets are largely or completely exempted. While the international Basel III agreements incorporate many of the lessons learned from the crisis, there were other key concerns that were not addressed in those standards, but which are important for promoting the resiliency and stability of the U.S. banking system—for example, the importance of better differentiating risks in mortgage lending. The U.S. proposed rules attempt to address these additional elements as well.

We recognize that the proposed changes represent a comprehensive reform of regulatory capital standards and that the burden of reviewing and assessing the impact of new regulatory proposals can weigh especially heavily on community banks. This

* Statement Required by 12 U.S.C. §250: The views expressed herein are those of the Office of the Comptroller of the Currency and do not necessarily represent the views of the President.

[1] Testimony of John Walsh, Acting Comptroller of the Currency, before the Committee on Banking, Housing, and Urban Affairs, United States Senate (March 22, 2012).

is why we have taken several measures to reduce the burden of this rulemaking process for these banks—in the way we organized the proposals, in outreach we have conducted, and by distributing a tool to help bankers assess the potential impact of the proposals on their capital requirements.

We also appreciate that the burden for community banks lies not only in reviewing and understanding the proposals, but also in complying with them. In this context, it is important to remember that these are proposed rules, not final rules, and we are very interested in feedback on all aspects of these proposals. We posed over 80 specific questions in the proposals, including questions related to regulatory burden, to elicit comments on all aspects of the proposals.

In my testimony today, I will review briefly the proposed capital rules and then discuss three of the major issues raised in the comments we have received. These issues are: (1) the overall complexity of the proposals and questions about their applicability to, and appropriateness for, community banks; (2) the proposed treatment of unrealized losses (and gains) in regulatory capital; and (3) the treatment of real estate lending, particularly residential mortgages.

The Proposed Capital Rules

In June, the agencies published three notices of proposed rulemaking (NPRs)—the Basel III NPR, the Standardized Approach NPR, and the Advanced Approaches NPR.[2] Many, but not all, of the provisions contained in two of these three NPRs—the Basel III NPR and the Standardized Approach NPR—would apply to all banks, including community banks.

The Basel III NPR would raise the quantity and quality of capital required to meet minimum regulatory standards. The Standardized Approach NPR seeks to address shortcomings in the way capital is aligned with risks in our current rules. The Advanced Approaches NPR would require the largest banks, when calculating regulatory capital, to take a more complete and accurate account of their risks, both on- and off-balance sheet. The Basel III and Advanced Approaches NPRs would significantly raise capital standards for large banks. Taken together, the three NPRs address the risks that contributed to the recent financial crisis and aim to enhance the safety and soundness of the U.S. banking system.

Turning to the first of the three NPRs, the Basel III NPR concentrates largely on improving the reliability with which banks of all sizes can absorb future losses. It covers both the definition and the minimum required levels of capital. The NPR proposes a new measure for regulatory capital called Common Equity Tier 1 (CET1). This measure was introduced because some of the instruments that qualified under the broader existing definitions of regulatory capital did not dependably absorb losses during the crisis and the subsequent economic downturn.

The proposed minimum standard for CET1 is 4.5 percent of risk-weighted assets. On top of this, the NPR introduces two new capital buffers—the capital conservation buffer and the countercyclical buffer.

The proposed capital conservation buffer is 2.5 percent of risk-weighted assets, which would bring the effective CET1 requirement up to 7 percent of risk-weighted assets. If a bank's CET1 ratio were to fall below that level, capital distributions and discretionary bonus payments would be restricted. This buffer would apply to banks of all sizes. During the recent financial crisis and economic downturn, some banks continued to pay dividends and substantial discretionary bonuses even as their financial condition weakened; the capital conservation buffer is intended to limit such practices and conserve capital at individual banks and for the banking system as a whole.

The countercyclical capital buffer would apply only to the largest internationally active banks with assets in excess of $250 billion or foreign exposures of more than $10 billion. If activated by the agencies during the expansionary stage of a credit cycle, it could increase the minimum CET1 buffer by as much as another 2.5 percent of risk-weighted assets. The intent of the countercyclical capital buffer is to increase capital requirements during periods of rapid economic growth to reduce the excesses in lending and to protect against the effects of weakened underwriting standards during subsequent contractions.

A separate surcharge on systemically important banks (the so-called "SIFI surcharge"), which is to be the subject of a separate rulemaking, could potentially add

[2] "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action" (Basel III NPR), 77 *Fed. Reg*. 52792; "Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements" (Standardized Approach NPR), 77 *Fed. Reg.* 52888; and "Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rule; Market Risk Capital Rule" (Advanced Approaches NPR) 77 *Fed. Reg.* 52978.

another 3.5 percent of risk-weighted assets to the risk-based capital requirements of the largest banks. The cumulative effect of the countercyclical buffer and the potential SIFI requirement is that during an upswing in the credit cycle, some large U.S. banks may be required to hold CET1 equal to as much as 13 percent of their risk-weighted assets. This difference in potential capital requirements—i.e., as much as 13 percent for large banks compared with 7 percent for small banks—is intended to appropriately distinguish between their relative riskiness.

In addition to risk-based capital standards, all U.S. financial institutions are subject to a leverage ratio that is designed to limit the overall amount that a bank can leverage its capital. In this regard, another way in which the proposals differentiate between banks of different sizes is the new supplementary leverage ratio introduced in the Basel III NPR. This ratio would be set at 3 percent of adjusted assets and would apply only to large internationally active banks. It is a more demanding standard than the existing 4 percent leverage requirement that already applies to all banks because it would include certain off-balance-sheet exposures. If this proposed change is implemented, small banks would be subject to only one leverage ratio requirement whereas large banks would have to meet two requirements.

While the Basel III NPR focuses on raising the quality and quantity of capital, the Standardized Approach NPR seeks to ensure that riskier activities require more capital. To accomplish this, the Standardized Approach NPR would revise the capital treatment for exposures to non-U.S. sovereigns, residential mortgages, commercial real estate, securitizations, and equities, and revise and expand the recognition of credit risk mitigation through collateral and guarantees. It also would introduce new disclosure requirements for banks over $50 billion in assets, as a means to impose additional market discipline. This disclosure requirement would not apply to community banks. Finally, the Standardized Approach NPR would remove external credit ratings from the capital standards in accordance with section 939A of the Dodd-Frank Act.

The Advanced Approaches NPR applies only to the largest, internationally active banks. This NPR includes several changes to the calculation of risk-weighted assets for counterparty exposures so that sufficient capital will be required for this source of risk that was found to be significant during the recent financial crisis.

In developing the June proposals, we were keenly aware of their potential impact, particularly on smaller banks throughout the country. The proposals include lengthy transition provisions and delayed effective dates to reduce the likelihood of adverse effects from increases in minimum required regulatory capital. For example, the revised risk weights included in the Standardized Approach NPR would not go into effect until 2015, and some of the transitional provisions related to capital instruments in the Basel III NPR extend out to 2022.

We assessed the potential effects of the proposed rules on banks by using regulatory reporting data and certain key assumptions, which we noted in the preamble to the proposals.[3] Our assessments indicate that many community banks hold capital well above both the existing and the proposed regulatory minimums. Many of the largest, internationally active banks already have strengthened their regulatory capital levels to meet the proposed minimum standards, particularly the new CET1 standard, in order to meet market participants' expectations. Establishing higher minimum standards for all banks would reinforce the financial strength of the banking sector in the future and the stability of the U.S. financial system.

While we did consider the potential impact of the proposals on banks and the banking system as we were developing them, one of the key purposes of the notice and comment process is to gain a better understanding of the potential impact of the proposals on banks of all sizes. As previously noted, to foster feedback from community banks on potential effects of the proposals, the agencies developed and posted on their respective Web sites an estimator tool that allowed smaller banks to use bank-specific information to assess the likely impact on their individual institution.

Issues Raised in Comment Letters

1. Complexity and Applicability

Commenters have raised an overarching concern about the complexity of the rules. More specifically, many comments have stated that the residential mortgage provisions in the Standardized Approach NPR are too complex. The NPR would separate mortgages into two risk categories based on product and underwriting characteristics and then, within each category, assign several new risk weights based on loan-to-value ratios (LTVs). Commenters were concerned about the costs associated

[3] See the attached impact assessment on OCC-regulated banks and thrifts pursuant to the Unfunded Mandates Reform Act.

with reviewing the existing book of mortgages and creating new systems to accommodate the more granular treatment of risks under the proposed approach. Under today's standards, all mortgages are assigned just one of two weights based on criteria that are relatively simple to administer.

Commenters also raised concerns about complexities resulting from these capital proposals in combination with other regulatory initiatives. For example, banks of all sizes have raised concerns about the interactions between some of the provisions of the proposals and certain aspects of the Dodd-Frank Act. In particular, some commenters raised concerns about the interplay and overall effect that the proposed treatment for residential mortgages will have on the housing sector and availability of mortgage loans when combined with the pending regulations related to the definitions of "qualified mortgage" (QM) and "qualified residential mortgage" (QRM).[4] In developing the treatment for residential mortgages, the agencies were mindful of the proposed definitions of QM and QRM and specifically requested comment on whether mortgages that meet the QM definition should be included in the lower risk category of residential mortgage.

Some commenters suggested that, given the complexity of the proposals, the best way to reduce regulatory burden on community banks would be to delay the implementation of the Standardized Approach NPR or to exempt community banks altogether from any new capital rules. In this vein, many commenters observed that community banks did not cause the crisis, and therefore should be exempted. We will carefully consider these comments as well as suggestions for improving the NPR.

As noted earlier, we have taken steps to try to ease the burden of understanding the proposed set of rules for community banks. Nevertheless, we recognize that understanding and complying with the proposed rules could still be difficult for community banks. However, it is also important to recognize that the proposed rules are lengthy, in part, because they address banks of all shapes and sizes including banks involved in complex or risky activities, instruments, or lines of business. Banks engaged in these activities are not necessarily only the largest banks in the country but also can include smaller banks that engage in one or two complex or riskier activities. The proposed rules are comprehensive in their coverage and would therefore address such instances. The vast majority of community banks, however, will not need to consider many of these provisions.

Finally, it is important to remember that over 460 smaller banks have failed in the aftermath of the financial crisis for a variety of reasons but, ultimately, because they did not have enough capital in relation to the risks that they took. The future safety and soundness of community banks will depend on their having sufficient capital going forward.

2. Unrealized Losses

Another major issue raised by commenters is the inclusion of unrealized losses (and gains) on available-for-sale (AFS) debt securities in regulatory capital. Under our existing standards, such unrealized losses generally do not affect a bank's regulatory capital.[5] In contrast, under the Basel III NPR, unrealized losses on AFS debt securities would directly impact a bank's regulatory capital.[6] The rationale for the

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[4] Proposed regulations relate to the definition of "qualified mortgage" under regulations to be issued by the Consumer Financial Protection Bureau pursuant to the Truth in Lending Act (as revised by section 1412 of the Dodd-Frank Act), as well as the definition of "qualified residential mortgage" under the securitization risk retention regulations to be issued jointly by the Federal banking agencies, FHFA, SEC, and HUD pursuant to section 941 of the Dodd-Frank Act.

[5] Under the existing standards for national banks in 12 CFR Part 3, Appendix A, section 2, and for Federal savings associations in 12 CFR 167.5, Tier 1 capital (national banks) and core capital (Federal savings associations) include "common stockholders' equity." The definition of "common stockholders' equity" (listed at 12 CFR Part 3, Appendix A, section 1 for national banks and 12 CFR 167.1 for Federal savings associations) does not include unrealized gains or losses on AFS debt securities, but it does include unrealized losses on AFS equity securities with readily determinable fair values. Additionally, at 12 CFR Part 3, Appendix A, section 2(b)(5) (national banks) and 12 CFR 167.5(b)(5) (Federal savings associations), the current rules also provide that up to 45 percent of pretax net unrealized gains on AFS equity securities can be included in Tier 2 capital. 12 CFR Part 3, Appendix A, section 2(b)(5) (national banks) and 12 CFR 167.5(b)(5) (Federal savings associations), further provide that unrealized gains and losses on other assets, including AFS debt securities, may be taken into account when considering a bank's overall capital adequacy, however, those gains and losses are not specifically included in the determination of a bank's regulatory capital ratios.

[6] Section 20(a)(1) of the proposal defines the elements that make up common equity tier 1 capital. Those elements include accumulated other comprehensive income (AOCI). Under U.S. GAAP, AOCI is comprised of four elements: (1) unrealized gains and losses on AFS securities (ASC Topic 320, Investments—Debt and Equity Securities); (2) gains and losses on derivatives held as effective cash flow hedges (ASC Topic 815, Derivatives and Hedging); (3) recognized ac-

proposal is that ignoring unrealized losses has the potential to mask the true financial position of a bank. This is particularly true when a bank is under stress and when creditors are most likely to be concerned about unrealized losses that could inhibit a bank's ability to meet its obligations.

Many bankers have commented that the inclusion of unrealized gains and losses on AFS debt securities could result in large and volatile changes in capital levels and other measures tied to regulatory capital, such as legal lending limits, especially when interest rates rise from the current low levels. Because these gains and losses often result from changes in interest rates rather than changes in credit risk, commenters also noted that the value of these assets on any particular day might not be a good indicator of the value of a security to a bank, given that the bank could hold the security until its maturity and realize the amount due in full (assuming no credit related issues).

There are strategies available to banks to minimize some of these potential adverse effects on regulatory capital. Banks could increase their capital, hedge or reduce the maturities of their AFS securities, or shift securities into the held-to-maturity portfolio at the cost of reducing liquidity. However, commenters have stated that these strategies are all expensive and some strategies, such as hedging or raising additional capital, may be especially expensive and difficult for community banks. Commenters also have noted that under the proposed approach, offsetting changes in the value of other items on a bank's balance sheet would not be recognized for regulatory capital purposes when interest rates change. As a result, they stated that the proposed treatment could greatly overstate the real impact of interest rate changes on the safety and soundness of the bank.

The agencies anticipated many of the concerns raised by commenters on this issue and included a discussion within the Basel III NPR requesting comment on potentially excluding from regulatory capital unrealized gains and losses associated with U.S. Treasury and GSE debt that can be expected to be driven solely by interest rates. Under such an approach, other unrealized losses and gains—for example, those associated with a corporate bond—would be recognized in regulatory capital. The OCC recognizes the importance of this issue and the challenges the proposed treatment could present to banks, particularly community banks, in managing their capital, liquidity, and interest rate risk positions and in affecting their ability to lend to their communities. We are committed to reviewing this issue carefully.

3. Real Estate Lending

Another major concern of commenters relates to the proposed treatment for residential mortgages, and, to a lesser extent, commercial real estate. These provisions in the Standardized Approach NPR attempt to address some of the causes of the crisis—the collapse in residential mortgage underwriting standards and the prevalence of higher risk commercial real estate loans in some banks. Under our current rules, residential mortgages within a broad spectrum of risk attributes receive identical capital treatment. The treatment of commercial real estate loans is even less risk sensitive in that all such loans receive the same capital treatment. The proposed standard would raise the capital requirement for the riskiest mortgages and commercial real estate loans while actually lowering the charge on relatively safer residential mortgage loans.

Some of the major issues that commenters have raised relate to: the treatment of residential balloon mortgages; recordkeeping issues associated with the proposed use of LTV ratios; the treatment of second liens and commercial real estate; and the potential impact on the housing market. With respect to residential balloon mortgages, the concentration of credit risk in the final balloon payment presents more risk to the lender than a loan that is fully amortized over a number of years—especially in situations where housing prices are not increasing. Therefore, the NPR proposes a relatively high capital charge.[7] Many community bankers have questioned this assumption and noted their good experience with balloons and their wide use in managing interest rate risk and providing credit to established customers.

On the recordkeeping that would be required for LTVs, while higher LTV ratios are closely associated with higher risks of default, many community bankers have stated that going back through their existing portfolios to determine each loan's

tuarial gains and losses on defined benefit plans (ASC Topic 715, Compensation—Retirement Benefits); and (4) gains and losses resulting from currency translation of foreign subsidiaries financial statements (ASC Topic 830, Foreign Currency Matters). Under the existing capital standards, items one through three of AOCI are not included in regulatory capital.

[7] Under the proposals, balloon mortgages would receive risk weights between 100 and 200 percent, depending on the loan's LTV.

LTV at origination would be a burdensome task. For this reason, some have suggested applying the proposed treatment prospectively.

Commenters have also raised concerns with the proposed treatments for second lien residential mortgages, such as home equity loans, and for certain commercial real estate loans. Similar to issues raised with balloon mortgages, commenters have expressed concern that the proposed rules do not adequately distinguish between prudent and more risky lending in such products.

With respect to broader implications for the housing market, while the proposal would actually lower capital requirements for the safest mortgages, it would also raise capital requirements for riskier mortgages, which could raise the incremental costs of such mortgages. Commenters have raised concerns about the impact this might have on recovery of the housing sector.

The OCC will pay attention to the unique and intimate knowledge that community banks possess of their customers and their lending relationships as we review the range of issues raised by commenters on our proposed treatment of real estate lending.

Conclusion

Given the attention that the regulatory capital proposals have received recently, let me conclude by taking a moment to put these proposals in a broader perspective. Specifically, regulatory capital standards are an important component in a larger and more comprehensive process of bank supervision. They cannot and should not be viewed as a substitute for other assessments of a bank's financial position, including banks' internal capital adequacy assessments. They should be viewed as complementary to strong supervision of institutions, which requires in-depth and bank-specific analysis.

With this as the context, I want to reemphasize that we are still in the process of reviewing the many comment letters that we have received. We will carefully assess the advantages and disadvantages of the alternatives suggested, including assessing regulatory burden against the value of more and better quality capital that is better aligned to actual risks. As the Comptroller said last month, "As we finalize the rules, we will be thinking broadly about ways to reduce regulatory burden. As well as considering the substance of each provision, we will be taking a fresh look at the possible scope for transition arrangements, including the potential for grandfathering, to evaluate what we can do to lighten burden without compromising our two key principles of raising the quantity and quality of capital and setting minimum standards that generally require more capital for more risk." [8]

Given the vital role that banks serve in our national economy and local communities, we are committed to helping ensure that the business model of banks, both large and small, remains vibrant and viable. But, as a foundation for their future success, their capital has to stay strong too. If we can help ensure that, then we will be well along the road in ensuring that there is a stable and competitive banking system meeting household and business credit needs across America in the years ahead.

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[8] Remarks by Thomas J. Curry, Comptroller of the Currency, before the American Bankers Association in San Diego, California, October 15, 2012.

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Carl Kaminski, Legislative and Regulatory Activities

Thru: Gary Whalen, Director, Policy Analysis Division

From: Douglas Robertson, Senior Financial Economist, Policy Analysis Division

Date: May 30, 2012

Subject: Impact Assessment for the Basel III Rule: General Capital Rules, NPR1

This memorandum provides our assessment of the economic impact of the proposed rules that would implement the Basel III framework developed by the Basel committee on Banking Supervision. The Basel III framework would revise current general risk-based capital rules and would be applicable to all banking organizations. The federal banking agencies are implementing Basel III through three separate rules. The first rule would apply Basel III minimum capital requirements to all banking organizations (NPR1). The second rule would implement new alternative measures of creditworthiness for general banking organizations (NPR2). The third rule would apply Basel III enhancements to institutions subject to the advanced approaches capital rules (NPR3). Advanced approaches banking organizations are those institutions with total assets of at least $250 billion or foreign exposures of at least $10 billion, or institutions that have elected to adopt the advanced approaches.

1) Basel III NPR (NPR1)
This will include the changes to the numerator of the risk-based capital ratio, the new ratio requirements (common equity Tier 1 and the higher minimums), as well as the conservation and countercyclical buffers. It also will include the changes to the treatment of mortgage servicing assets and deferred tax assets (DTAs).

2) Standardized Approach NPR (NPR2)
This will include the changes to the calculation of risk-weighted assets (the denominator of the risk-based capital ratio), except for the treatment of mortgage servicing assets and DTAs discussed in the Basel III NPR).

3) Advanced Approaches NPR (NPR3)
The advanced approaches NPR will introduce enhancements to the advanced approaches rule, and it will include a proposal to expand the scope of the market risk rule to include thrifts.

We estimate that the first-year cost associated with higher minimum capital requirements in NPR1 will be approximately $5.1 million. We estimate that the first-year cost associated with changes in risk-weighted assets and implementation of alternative measures of creditworthiness in NPR2 will be approximately $93.2 million. We estimate that the first-year cost associated with changes in risk-weighted assets and simultaneously meeting new market risk capital requirements in NPR3 will be approximately $46.8 million. Together, we estimate that the overall cost of the three Basel III rules will be approximately $145.1 million in the first year. After introducing new systems for determining risk weighted assets in the first year, we estimate that the overall cost of Basel III in subsequent years will decrease to approximately $98.6 million per year.

I. The Proposed Rule: Minimum Regulatory Capital Ratios (NPR1)

The proposed rule would implement Basel III and has the following major elements. The proposed rule would:

1. Introduce a new common equity Tier 1 capital ratio
2. Introduce a higher minimum Tier 1 capital ratio
3. Introduce a supplementary leverage ratio for advanced approaches banks
4. Introduce new capital conservation buffer
5. Introduce a countercyclical capital buffer for advanced approaches banks
6. Prompt Corrective Action thresholds: Introduce common equity Tier 1 thresholds and increase Tier 1 thresholds
7. Apply the proposed capital rules to savings and loan holding companies on a consolidated basis

The proposed rule also contains a reservation of authority that authorizes a banking organization's primary federal supervisor to require the banking organization to hold additional capital relative to what would be required under the proposed rule.

Section 1. Minimum Capital Requirements

Under the proposed rule, changes to minimum capital requirements include a new common equity Tier 1 capital ratio, a higher minimum Tier 1 capital ratio, a supplemental leverage ratio for advanced approaches banks, new thresholds for prompt corrective action purposes, a new capital conservation buffer, and a new countercyclical capital buffer for advanced approaches banks. All banking organizations would transition to the new minimum capital requirements between January 1, 2013, and January 1, 2019. Table 1 shows the transition table for minimum capital requirements under the proposed rule.

Although the proposed rule would also increase several prompt corrective action (PCA) thresholds, with the exception of the leverage ratio, the minimum capital conservation buffer in the proposal effectively requires all banking organizations in the United States to be well capitalized for PCA purposes by 2019. Adding the capital conservation buffer to minimum required capital ratios elevates the capital ratios above PCA well-capitalized thresholds beginning January 1, 2019.

Table 1.- Transition Schedule for Minimum Capital Requirements

	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019	PCA	
								Adq.	Well
Common Equity to Risk-Weighted Assets	3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%	4.5%	6.5%
Tier 1 to Risk-Weighted Assets	4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%	6%	8%
Total Capital to Risk-Weighted Assets	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8%	10%
Conservation Buffer to Risk-Weighted Assets				0.625%	1.25%	1.875%	2.5%		
Maximum Advanced Approaches Countercyclical Buffer				0.625%	1.25%	1.875%	2.5%		
Minimum Common Equity + Conservation Buffer	3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7.0%		
Minimum Tier 1 + Conservation Buffer	4.5%	5.5%	6.0%	6.625%	7.25%	7.875%	8.5%		
Minimum Total Capital + Conservation Buffer	8.0%	8.0%	8.0%	8.625%	9.125%	9.875%	10.5%		
Leverage Ratio	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4%	5%
Advanced Approaches Supplemental Leverage Ratio			Start to Report			3.0%	3.0%		

<u>Section 2. Eligibility Requirements for Regulatory Capital Instruments</u>

In addition to changing minimum required capital ratios, the proposed rule would also change what counts as capital. For instance, the proposed rule would increase deductions from regulatory capital for deferred tax assets, it would limit the inclusion of minority interests in capital, and unrealized gains and losses on all available-for-sale securities would flow through to common equity tier one capital.

A. Common Equity Tier 1 Capital Ratio

The proposed rule would require banking organizations to maintain a minimum 4.5 percent ratio of common equity Tier 1 capital to total risk-weighted assets. To be a well-capitalized institution under Prompt Corrective Action (PCA) regulations, banking organizations would need to maintain a minimum ratio of 6.5 percent.

Under the proposed rule, common equity Tier 1 capital would equal the sum of common stock and related surplus (net of any Treasury stock), retained earnings, accumulated other comprehensive income (AOCI), and common equity Tier 1 minority interest subject to limits minus regulatory adjustments and deductions. Qualifying common stock instruments would have to satisfy certain criteria. The banking agencies expect that the vast majority of existing common stock will fully satisfy these criteria.

New deductions from common equity Tier 1 capital include the following:

a. Mortgage Servicing Assets (MSAs)
b. Deferred tax assets (DTAs)
c. Investments in the capital of an unconsolidated financial institution above a threshold
d. Changes in accumulated other comprehensive income (AOCI) without adjustments for gains and losses in available-for-sale debt securities
e. Investments in hedge funds and private equity funds consistent with the Volcker Rule[1]

B. Tier 1 Capital: Additional Tier 1

Under the proposed rule, total Tier 1 capital would equal the sum of common equity Tier 1 capital and additional Tier 1 capital. Additional Tier 1 capital equals the sum of noncumulative perpetual preferred, related surplus, other Tier 1 minority interest, and various SBLF and EESA qualifying instruments less certain adjustments and deductions. Trust preferred securities would no longer be eligible for inclusion in Tier 1 capital. Additional Tier 1 capital instruments must also satisfy certain criteria. In essence, these instruments must be subordinated, have fully discretionary non-cumulative dividends, have no maturity date, have no incentives to redeem, and must be able to absorb losses. Instruments currently included in Tier 1 capital that do not meet the new criteria will be phased out of the Tier 1 regulatory capital calculation beginning in January 1, 2014 and will be 100 percent phased out beginning January 1, 2018, except for trust-preferred securities, which must be phased out according to a different timeline set forth in section 171 of the Dodd-Frank Act.

C. Tier 2 Capital

[1] This deduction is consistent with the proposed Volcker Rule. In our impact assessment for that rule, we estimated that banking organizations could invest in hedge funds and private equity funds up to as much as three percent of Tier 1 capital. As this deduction depends on the still pending final Volcker Rule, we defer assessment of the cost of this deduction until we conduct our economic impact analysis of the final Volcker Rule.

The proposed rule will also adjust Tier 2 capital elements. Tier 2 capital instruments must satisfy eligibility criteria as well. In particular, the instrument must have an original maturity of at least 5 years. Under the proposed rule, banking organizations may include limited amounts of common equity of a consolidated depository institution subsidiary.

D. Leverage Ratio

The proposed rule would require advanced approaches banks to maintain a three percent minimum Basel 3 leverage ratio in addition to the current U.S. leverage ratio. The Basel 3 leverage ratio is defined as a ratio of Tier 1 capital to a sum of on-balance sheet and certain off-balance sheet assets. The Basel 3 leverage ratio would supplement the current U.S. leverage ratio, which only includes on-balance sheet items in the ratio's denominator.

E. Capital Conservation and Countercyclical Buffers

The proposed rule would require all banking organizations to hold common equity Tier 1 capital in the form of a capital conservation buffer. The capital conservation buffer would begin to phase-in on January 1, 2016 and be fully phased-in at 2.5 percent of risk-weighted assets on January 1, 2019. Combined with other minimum capital requirements, the capital conservation buffer effectively requires banks to maintain a 7 percent common equity Tier 1 ratio, an 8.5 percent Tier 1 ratio, and a 10.5 percent total risk-based capital ratio.

The proposed rule would also require advanced approaches banking organizations to hold additional common equity Tier 1 capital in a countercyclical buffer, which would range between zero and 2.5 percent of risk-weighted assets. The countercyclical buffer would apply when the primary federal regulator determines (using various guide variables) that a period of excessive credit growth is contributing to an increase in systemic risk. The regulator would generally announce the level of the buffer 12 months in advance of its implementation, but may give shorter notice if necessary.

Institutions that do not meet the capital conservation buffer or the countercyclical capital buffer requirements would be subject to limitations on capital distributions and incentive compensation payments proportional to the shortfall in the buffer. A banking organization that operates in multiple jurisdictions would have to calculate its countercyclical capital buffer as the weighted average of the countercyclical capital buffer for each jurisdiction.

II. <u>Institutions Affected By the Proposed Rule</u>

The proposed minimum capital requirements will apply to all banking organizations. According to December 31, 2011 Call Report data, there are 7,432 FDIC-insured institutions. After aggregating to the highest holding company, there are 6,744 bank holding companies, of which, 1,213 are national banking organizations.[2] Excluding several thrifts that are included as subsidiaries of national banking organizations, the proposed rule would also apply to 612 federally chartered private savings institutions. Thus, the proposed rule would apply to 1,825 financial institutions regulated by the OCC.

III. Estimated Costs and Benefits of the Proposed Rule

The various elements of the proposed rule will affect costs in three ways: (1) the cost of capital institutions will need to meet the higher minimum capital ratios and the new eligibility standards for capital, (2) compliance costs associated with establishing the infrastructure to determine correct risk weights using the new alternative measures of creditworthiness, and (3) compliance costs associated with new disclosure requirements. Some institutions will also incur costs associated with new capital requirements for exposures to central counterparties and changes to recognized collateral and eligible guarantors, but we subsume these expenses into our general cost of capital estimates. In this analysis of the proposed rule covering minimum capital requirements, we only estimate the cost of capital necessary to make up any projected shortfall between current capital levels and the proposed rule's new minimum capital requirements.

Benefits of the Proposed Rule

The proposed rule would produce the following benefits:

1. Improves the quality of regulatory capital by introducing a common equity Tier 1 regulatory capital requirement and tightening the standards for including non-common equity instruments in regulatory capital
2. Increases risk sensitivity of capital requirements and risk-weighted assets
3. Improves loss absorbency of regulatory capital
4. Improve transparency and market discipline through disclosure requirements.
5. Enhanced supervisory review process through the establishment of Pillar 2-based expectations for banking organizations
6. Enhances counterparty credit risk capital requirements that proved inadequate during the financial crisis

Costs of the Proposed Rule

To estimate the impact of the proposed rule on bank capital needs, we estimate the amount of capital banks will need to amass to meet the new minimum standards relative to the amount of capital they currently hold. To estimate new capital ratios and requirements, we use currently available data from banks' quarterly Consolidated Report of Condition and Income (Call Reports) to approximate capital under the proposed rule. We arrive at our estimates of the new numerators of the capital ratios by combining various Call Report items to reflect definitional changes to common equity capital, Tier 1 capital, and total capital as described in the proposed

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[2] A national banking organization is any bank holding company with a subsidiary national bank. Two of the 16 organizations also include a federally chartered private savings institution, but both of these organizations also contain a national bank and are included in the 16 national banking organizations.

rule. The capital ratio denominator, risk-weighted assets, will also change under the proposed rule. However, because the idiosyncratic nature of each institution's asset portfolio will cause the direction and extent of the change in the denominator to vary from institution to institution, we are unable to estimate risk-weighted assets under the proposed rule. Instead, we use the current definition of risk-weighted assets and thus the amount reported by institutions in their most recent Call Report.

Using our estimates of the proposed capital ratio numerators and holding these capital levels constant through 2019, we estimate the capital shortfall each institution would encounter as the new capital ratios come into effect according to the schedule shown in table 1. Table 2 shows our estimates of the number of institutions that would not meet the transition schedule for minimum capital requirements using data as of December 31, 2011. Table 3 shows our estimates of the aggregate amount of capital shortfall over the transition period ending in 2019. While institutions must simultaneously meet all of the minimum capital requirements, the largest shortfall amount in any given year shows the most binding minimum capital requirement. The number of institutions and the capital shortfall amounts shown in the 2016 column reflect those institutions that show a shortfall with regard to the new PCA standards relative to current capital levels.

As shown in table 3, our estimate of the largest capital shortfall would be a $1,111 million shortfall in total capital plus the capital conservation buffer in 2019. However, a slightly smaller shortfall of $1,088 million arrives four years earlier when the new Tier 1 PCA standard for well-capitalized institutions takes effect on January 1, 2015. We view this new PCA Tier 1 standard as the earliest significant capital constraint in the proposed rule.

Because banks confronting a capital shortfall under the proposed rule will need to gradually increase their capital levels to meet the proposed transition schedule, the aggregate cost of increasing capital will be spread out over several years. We estimate that the largest shortfall for any given year will be approximately $900 million to meet the new PCA Tier 1 standard for well-capitalized institutions when it takes effect in 2015. This estimate combines the capital needs for national banking organizations and federally chartered private savings institutions (together, OCC institutions).

To estimate the cost to banks of the new capital requirement, we examine the effect of this requirement on capital structure and the overall cost of capital.[3] The cost of financing a bank or any firm is the weighted average cost of its various financing sources, which amounts to a weighted average cost of capital reflecting many different types of debt and equity financing. Because interest payments on debt are tax deductible, a more leveraged capital structure reduces corporate taxes, thereby lowering funding costs, and the weighted average cost of financing tends to decline as leverage increases. Thus, an increase in required equity capital would force a bank to deleverage and – all else equal – would increase the cost of capital for that bank.

[3] See Merton H. Miller, (1995), "Do the M & M propositions apply to banks?" *Journal of Banking & Finance*, Vol. 19, pp. 483-489.

This increased cost would be tax benefits foregone: the capital requirement ($900 million), multiplied by the interest rate on the debt displaced and by the effective marginal tax rate for the banks affected by the proposed rule. The effective marginal corporate tax rate is affected not only by the statutory federal and state rates, but also by the probability of positive earnings (since there is no tax benefit when earnings are negative), and for the offsetting effects of personal taxes on required bond yields. Graham (2000) considers these factors and estimates a median marginal tax benefit of $9.40 per $100 of interest. So, using an estimated interest rate on debt of 6 percent, we estimate that the annual tax benefits foregone on $900 million of capital switching from debt to equity is approximately $900 million * 0.06 (interest rate) * 0.094 (median marginal tax savings) = $5.1 million per year.[4]

The banking agencies will also incur some modest costs associated with macro-prudential monitoring. Under the proposed rule, the agencies would need to monitor credit growth through the use of various guide variables such as credit default swap spreads, funding spreads, and asset prices. We estimate that this macro-prudential monitoring will involve approximately 192 hours per year per agency. This estimate assumes that the monitoring and reporting will involve two individuals for eight hours a month (2 x 8 x 12 = 192). Applying our wage estimate of $85 per hour, we estimate that the total cost of macro-prudential monitoring and reporting will be approximately $48,960 per year for all three banking agencies ($85 x 192 x 3 = $48,960).

Our overall estimate for this segment of the Basel III proposal is $5.1 million per year.

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[4] See John R. Graham, (2000), How Big Are the Tax Benefits of Debt?, *Journal of Finance*, Vol. 55, No. 5, pp. 1901-1941. Graham points out that ignoring the offsetting effects of personal taxes would increase the median marginal tax rate to $31.5 per $100 of interest.

Table 2. – Cumulative Number of OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	5	8	12	13	25			
	FCPSIs	7	12	12	12	18			
	Total	12	20	24	25	43			
Tier 1 to Risk-Weighted Assets	NBOs	10	10	12	16	30			
	FCPSIs	10	11	13	16	21			
	Total	20	21	25	32	51			
Minimum Total Capital + Conservation Buffer	NBOs	22				27	27	31	39
	FCPSIs	17				18	22	27	28
	Total	39				45	49	58	67
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

Table 3. – Capital Shortfall for Scheduled Minimum Capital Requirements, ($ in millions) December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$18	$42	$54	$67	$357			
	FCPSIs	$51	$83	$100	$117	$202			
	Total	$69	$125	$154	$184	$559			
Tier 1 to Risk-Weighted Assets	NBOs	$25	$32	$62	$79	$849			
	FCPSIs	$49	$62	$88	$110	$239			
	Total	$74	$94	$150	$189	$1,088			
Minimum Total Capital + Conservation Buffer	NBOs	$169				$271	$355	$498	$670
	FCPSIs	$152				$189	$228	$342	$441
	Total	$321				$460	$583	$840	$1,111
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

Regulatory Flexibility Act (RFA) Analysis

As part of our analysis, we considered whether the proposed rule is likely to have a significant impact on a substantial number of small entities, pursuant to the RFA. The size threshold for small banks is $175 million. Tables 4 and 5 show our estimates of the number and capital shortfall for small institutions under the proposed rule. We estimate that the cost of lost tax benefits associated with increasing total capital by $82 million as shown in table 5 will be approximately $0.5 million per year. Averaged across the 28 affected institutions, the cost is approximately $18,000 per institution per year. Among the small institutions facing a potential capital shortfall over the transition period, this cost would only be significant for three of these institutions when measured against total noninterest expenses. Thus, we believe that this proposed rule will not have a significant impact on a substantial number of small entities.

Table 4. – Cumulative Number of Small OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	4	6	8	9	12			
	FCPSIs	2	3	3	3	6			
	Total	6	9	11	12	18			
Tier 1 to Risk-Weighted Assets	NBOs	7	7	8	10	14			
	FCPSIs	2	3	3	4	6			
	Total	9	10	11	14	20			
Minimum Total Capital + Conservation Buffer	NBOs	11				14	14	15	19
	FCPSIs	4				4	5	9	9
	Total	15				18	19	24	28

Table 5. – Capital Shortfall for Small OCC-Regulated Banking Organizations for Scheduled Minimum Capital Requirements, ($ in millions) December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$9	$17	$20	$23	$39			
	FCPSIs	$1	$2	$2	$2	$5			
	Total	$10	$19	$22	$25	$44			
Tier 1 to Risk-Weighted Assets	NBOs	$21	$24	$30	$33	$54			
	FCPSIs	$1	$1	$2	$2	$8			
	Total	$22	$25	$32	$35	$62			
Minimum Total Capital + Conservation Buffer	NBOs	$40				$46	$52	$61	$69
	FCPSIs	$3				$5	$6	$10	$13
	Total	$43				$51	$58	$71	$82

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Carl Kaminski, Legislative and Regulatory Activities

Thru: Gary Whalen, Director, Policy Analysis Division

From: Douglas Robertson, Senior Financial Economist, Policy Analysis Division

Date: May 30, 2012

Subject: Impact Assessment for Basel III: Standardized Approaches to Risk-weighted Assets, NPR2

This memorandum provides our assessment of the economic impact of the proposed rules that would implement the Basel III framework developed by the Basel Committee on Banking Supervision. The Basel III framework would revise current general risk-based capital rules and would be applicable to all banking organizations. The federal banking agencies are implementing Basel III through three separate rules. The first rule would apply Basel III minimum capital requirements to all banking organizations (NPR1). The second rule would implement new alternative measures of creditworthiness for all banking organizations (NPR2).[1] The third rule would apply Basel III enhancements to the risk-weighted assets of institutions subject to the advanced approaches capital rules (NPR3).

1) Basel III NPR (NPR1)
This will include the changes to the numerator of the risk-based capital ratio, the new ratio requirements (common equity Tier 1 and the higher minimums), as well as the conservation and countercyclical buffers. It also will include the changes to the treatment of mortgage servicing assets and deferred tax assets (DTAs).

2) Standardized Approach NPR (NPR2)
This will include the changes to the calculation of risk-weighted assets (the denominator of the risk-based capital ratio), except for the treatment of mortgage servicing assets and DTAs discussed in the Basel III NPR.
3) Advanced Approaches NPR (NPR3)
The advanced approaches NPR will introduce enhancements to the advanced approaches rule, and it will include a proposal to expand the scope of the market risk rule to include thrifts.

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[1] These rules would serve as the generally applicable capital rules and therefore would be a floor for the risk-based capital requirement for advanced approaches banks under Section 171 of the Dodd Frank Act.

We estimate that the first-year cost associated with higher minimum capital requirements in NPR1 will be approximately $5.1 million. We estimate that the first-year cost associated with changes in risk-weighted assets and implementation of alternative measures of creditworthiness in NPR2 will be approximately $93.2 million. We estimate that the first-year cost associated with changes in risk-weighted assets and simultaneously meeting new market risk capital requirements in NPR3 will be approximately $46.8 million. Together, we estimate that the overall cost of the three Basel III rules will be approximately $145.1 million in the first year. After introducing new systems for determining risk weighted assets in the first year, we estimate that the overall cost of Basel III in subsequent years will decrease to approximately $98.6 million per year.

I. The Proposed Rule: Standardized Approach for Risk-weighted Assets (NPR2)

The proposed rule (NPR 2) includes changes to the general risk-based capital requirements that address the calculation of risk-weighted assets. The proposed rule would:

1. Revise the treatment of 1-4 family residential mortgages
2. Introduces a higher risk weight for certain past due exposures and acquisition and development real estate loans
3. Provides a more risk sensitive approach to exposures to non- U.S. sovereigns and non-U.S. public sector entities
4. Replace references to credit ratings with alternative measures of creditworthiness
5. Provides more comprehensive recognition of collateral and guarantees
6. Provides a more favorable capital treatment for transactions cleared through qualifying central counterparties
7. Introduces disclosure requirements for banking organizations with assets of $50 billion or more

Calculating Risk-Weighted Assets

Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) requires federal agencies to remove references to credit ratings from regulations and replace credit ratings with appropriate alternatives. The proposed rule would introduce alternative measures of creditworthiness for securitization positions and re-securitization positions. Table 1 summarizes changes in the proposed rule.

Table 1: Key Provisions of the Proposed Rule for Calculating Risk-weighted Assets

Aspect of Proposed Rule	Proposed Treatment
Risk-weighted Assets	
Credit exposures to: U.S. government and its agencies U.S. government-sponsored entities U.S. depository institutions and credit unions U.S. public sector entities, such as states and municipalities	Unchanged.
Credit exposures to: Foreign sovereigns Foreign banks Foreign public sector entities	Introduces a more risk-sensitive treatment using the Country Risk Classification measure produced by the Organization for Economic Cooperation and Development.
Corporate exposures	Assigns a 100 percent risk weight to corporate exposures, including exposures to securities firms.
Residential mortgage exposures	Introduces a more risk-sensitive treatment based on several criteria, including the loan-to-value-ratio of the exposure.
High volatility commercial real estate exposures	Applies a 150 percent risk weight to certain credit facilities that finance the acquisition, development or construction of real property.
Past due exposures	Applies a 150 percent risk weight to exposures that are not sovereign exposures or residential mortgage exposures and that are more than 90 days past due or on nonaccrual.
Securitization exposures	Maintains the gross-up approach for securitization exposures. Replaces the current ratings-based approach with a formula-based approach for determining a securitization exposure's risk weight based on the underlying assets and exposure's relative position in the securitization's structure.
Equity exposures	Introduces more risk-sensitive treatment for equity exposures.
Off-balance Sheet Items	Revises the measure of the counterparty credit risk of repo-style transactions. Raises the credit conversion factor for most short-term commitments from zero percent to 20 percent.
Derivative Contracts	Removes the 50 percent risk weight cap for

Aspect of Proposed Rule	Proposed Treatment
	derivative contracts.
Cleared Transactions	Provides preferential capital requirements for cleared derivative and repo-style transactions (as compared to requirements for non-cleared transactions) with central counterparties that meet specified standards. Also requires that a clearing member of a central counterparty calculate a capital requirement for its default fund contributions to that central counterparty.
Credit Risk Mitigation	Provides a more comprehensive recognition of collateral and guarantees.
Disclosure Requirements	Introduces qualitative and quantitative disclosure requirements, including regarding regulatory capital instruments, for banking organizations with total consolidated assets of $50 billion or more that are not subject to the separate advanced approaches disclosure requirements.

Alternative Measure for Securitization Positions

The alternative measure for securitization positions is a simplified version of the Basel II advanced approaches supervisory formula approach. The simplified supervisory formula approach (SSFA) applies a 100 percent risk-weighting factor to the junior most portion of a securitization structure equal to the amount of capital a bank would have to hold if it retained the entire pool on its balance sheet. For the remaining portions of the securitization pool, the SSFA uses an exponential decay function to assign a marginal capital charge per dollar of a tranche. Securitization positions for which a bank does not use the SSFA would be subject to a 100 percent risk-weighting factor. The proposed rule would also apply minimum risk weights to securitization tranches that would increase as cumulative losses to the pool increase. The proposed rule would allow institutions other than advanced approaches banking organizations to use the gross-up approach, which is similar to an approach provided for under current risk-based capital rules.

Alternative Measure for Exposures to Sovereign Entities

The proposed rule would assign capital requirements to sovereign exposures based on OECD Country Risk Classifications (CRCs). Risk weights would range from zero percent to 150 percent based on CRCs, and sovereigns that have defaulted on any exposure during the previous five years would have a 150 percent risk weight. Default would include a restructure that results in a sovereign entity not servicing an obligation according to its terms prior to the restructuring.

Exposures to the United States government and its agencies would always carry a zero percent risk weight. Sovereign entities that have no CRC would carry a 100 percent risk weight.

The proposed rule would apply a zero percent risk weight to exposures to supranational entities and multilateral development banks. International organizations that would receive a zero percent risk weight include the Bank for International Settlements, the European Central Bank, the European Commission, and the International Monetary Fund. The proposed rule would also apply a zero percent risk weight to exposures to 13 named multilateral development banks and any multilateral lending institution or regional development bank in which the U.S. government is a shareholder or member, or if the bank's primary federal supervisor determines that the entity poses comparable credit risk.

Other Positions

Corporate Exposures: The proposed rule would maintain current practice under general risk-based capital rules and assign a 100 percent risk weight to all corporate exposures.

Government Sponsored Entities (GSEs): The proposal would apply a risk weight of 20 percent to non-equity exposures and a 100 percent risk weight to preferred stock issued by a GSE.

Depository Institutions, Foreign Banks, and Credit Unions: Generally, the proposal would link depository institution risk weights to the sovereign entity risk weight. Under the proposal, sovereign entity risk weights may take one of the following percentage values: (0, 20, 50, 100, 150). Generally, exposures to foreign depository institutions would receive a risk weight one category higher than the risk weight assigned to the home sovereign. For instance, a bank based in a country that carries a zero percent risk weight would carry a 20 percent risk weight. If a country does not have a CRC, a bank based in that country also carries a 100 percent risk weight. Banks in countries with 150 percent risk weights would also carry 150 percent risk weights.

Residential Mortgage Exposures: The proposed rule would maintain the current risk-based capital treatment for residential mortgage exposures that are guaranteed by the U.S. government or its agency. Residential mortgage exposures that are unconditionally guaranteed by the U.S. government or a U.S. agency would receive a zero percent risk weight, and residential mortgage exposures that are conditionally guaranteed by the U.S. government or a U.S. agency would receive a 20 percent risk weight. A banking organization would divide other residential mortgages into one of two categories based on various loan characteristics such as duration, amortization, performance, and underwriting standards. These loans would then receive risk weights based on the loan-to-value ratio at the origination of the loan or at the time of restructuring. Table 2 shows the risk weights for residential mortgages.

Table 2 – Risk Weights for Residential Mortgage Exposures

Loan-to-value ratio (in percent)	Category 1 residential mortgage exposure (in percent)	Category 2 residential mortgage exposure (in percent)
Less than or equal to 60	35	100
Greater than 60 and less than or equal to 80	50	100
Greater than 80 and less than or equal to 90	75	150
Greater than 90	100	200

High Volatility Commercial Real Estate Exposures: The proposed rule would assign a 150 percent risk weight to any high volatility commercial real estate exposure. The proposed rule would generally define such an exposure as a loan that finances the acquisition, development, or construction of real property that is not a one- to four-family residential property or certain commercial real estate projects.

Public Sector Entities (PSEs): A PSE is a state, local authority, or other governmental subdivision below the level of a sovereign entity. The proposed rule would apply the same risk weights to exposures for U.S. states and municipalities as current general risk-based capital rules. Under the proposal, a banking organization would assign a 20 percent risk weight to a general obligation exposure to a U.S. PSE and a 50 percent risk weight to a revenue obligation exposure to such a PSE. For non-U.S. PSEs, the proposed rule would assign a risk weights based on the sovereign's CRC. One risk weight schedule would apply to general obligation claims and another schedule would apply to revenue obligations. Table 3 shows the risk-weight linkage for sovereigns and non-U.S. PSEs.

Table 3. Risk Weights for Exposures to Sovereigns and Public Sector Entities

Sovereign CRC	Sovereign Entity Risk Weights (in percent)	Non-U.S. PSE General Obligation Claim Risk Weights (in percent)	Non-U.S. PSE Revenue Obligation Risk Weights (in percent)
0-1	0	20	50
2	20	50	100
3	50	100	100
4-6	100	150	150
7	150	150	150
No CRC	100	100	100
Sovereign Default	150	150	150

Disclosure Requirements

The proposed rule would also introduce new disclosure requirements for banking organizations with $50 billion or more in total assets. The proposed rule would also introduce a Pillar 2 supervisory review process for all banking organizations.

II. Institutions Affected By the Proposed Rule

According to December 31, 2011 Call Report data, there are 7,432 FDIC-insured institutions. After aggregating to the highest holding company, there are 6,744 bank holding companies, of which, 1,213 are national banking organizations.[2] Excluding several thrifts that are included as subsidiaries of national banking organizations, the proposed rule would also apply to 612 federally chartered private savings institutions. Thus, the proposed rule would apply to 1,825 financial institutions regulated by the OCC. Banking organizations using the advanced approaches would not be affected by major portions of the proposed rule.

III. Estimated Costs and Benefits of the Proposed Rule

The various elements of the proposed rule will affect costs in three ways: (1) the cost of capital institutions will need to meet the higher minimum capital ratios and the new eligibility standards for capital, (2) compliance costs associated with establishing the infrastructure to determine correct risk weights using the new alternative measures of creditworthiness, and (3) compliance costs associated with new disclosure requirements.

Benefits of the Proposed Rule

The proposed rule would produce the following benefits:

1. Improves the quality of regulatory capital by introducing a common equity Tier 1 regulatory capital requirement and tightening the standards for including non-common equity instruments in regulatory capital
2. Increases risk sensitivity of capital requirements and risk-weighted assets
3. Improves loss absorbency of regulatory capital
4. Improve transparency and market discipline through disclosure requirements.
5. Expanded list of eligible third-party guarantors (page 143)
6. Expanded array of collateral types
7. Enhanced supervisory review process through the establishment of Pillar 2-based expectations for banking organizations
8. Enhances counterparty credit risk capital requirements that proved inadequate during the financial crisis

[2] A national banking organization is any bank holding company with a subsidiary national bank. Two of the 16 organizations also include a federally chartered private savings institution, but both of these organizations also contain a national bank and are included in the 16 national banking organizations.

Costs of the Proposed Rule

1. Impact of Risk-weighted Assets on Capital Requirements

Minimum required capital levels are likely to change under the proposed rule. The increased risk sensitivity of the alternative measures of creditworthiness implies that capital requirements may go down for some assets and up for others. For those assets with a higher capital charge under the proposed rule, however, that increase may be large in some instances, e.g., requiring a dollar-for-dollar capital charge for some securitization exposures.

The Basel Committee on Banking Supervision has been conducting periodic reviews of the potential quantitative impact of the Basel III framework. The quantitative impact study working group reported that the average change in risk-weighted assets for a global sample of larger banks (including some U.S. banks) was approximately 20 percent.[3] Although these reviews monitor the impact of implementing the Basel III framework rather than the provisions of the proposed rule, for the purposes of this analysis we consider the results of the Basel working group to be a best estimate and thus we increase risk-weighted assets by 20 percent to estimate the impact of the proposed rule on risk-weighted assets.

To estimate the impact of the proposed rule on bank capital needs, we estimate the amount of capital banks will need to amass to meet the new minimum standards described in our analysis of NPR1. As with that analysis, we estimate new capital ratios and requirements by combining various Call Report items to reflect definitional changes to common equity capital, Tier 1 capital, and total capital as described in NPR1. Because this proposed rule, NPR2, will change the capital ratio denominator, risk-weighted assets, we increase current risk-weighted assets by 20 percent. We use this 20 percent adjustment while recognizing that the idiosyncratic nature of each institution's asset portfolio will undoubtedly cause the direction and extent of the change in the denominator to vary considerably from institution to institution.

We thus construct new capital ratios reflecting the requirements of the proposed rules (NPR1 and NPR2) and estimate capital shortfalls as the difference between current capital levels and capital levels necessary to meet the new minimum standards. We estimate the capital shortfall each institution would encounter as the new capital ratios come into effect during the transition period from 2013 through 2019. Table 4 shows our estimates of the number of institutions that would not meet the transition schedule for proposed minimum capital requirements using data as of December 31, 2011. Table 5 shows our estimates of the aggregate amount of capital shortfall over the transition period ending in 2019. While institutions must simultaneously meet all of the minimum capital requirements, the largest shortfall amount in any given year shows the most binding minimum capital requirement. The number of institutions and the capital shortfall amounts shown in the 2016 column reflect those institutions that show a shortfall with regard to the new PCA standards relative to current capital levels.

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[3] The working group also reported an average change in risk-weighted assets for a global sample of smaller banks (those with Tier 1 capital less than €3 billion), but no U.S. banks participated in this sample. The reported average increase for this group was less than 10 percent, which suggests that our use of a 20 percent increase in risk-weighted assets for all institutions may overestimate the impact of the proposed rule.

As shown in table 4, our estimate of the largest capital shortfall would be an approximately $27 billion shortfall in 2015 when the new Tier 1 PCA standard for well-capitalized institutions takes effect. We view this new PCA Tier 1 standard as the major capital constraint in the proposed rule.

Because banks confronting a capital shortfall under the proposed rule will need to at least increase their capital levels gradually to meet the transition schedule, we assume that the aggregate cost of increasing capital will be spread out over several years. We estimate that the largest shortfall for any given year will be approximately $9.0 billion, or one third of the amount needed to meet the new PCA Tier 1 standard for well-capitalized institutions when it takes effect. This estimate combines the capital needs for national banking organizations and federally chartered private savings institutions (together, OCC institutions).

To estimate the cost to banks of the new capital requirement, we examine the effect of this requirement on capital structure and the overall cost of capital.[4] As with our estimate in NPR1, we estimate that the cost of the increase in capital would be tax benefits foregone: the capital requirement ($9.0 billion), multiplied by the interest rate on the debt displaced and by the effective marginal tax rate for the banks affected by the proposed rule. Graham (2000) estimates a median marginal tax benefit of $9.40 per $100 of interest. So, using an estimated interest rate on debt of 6 percent, we estimate that the annual tax benefits foregone on $9.0 billion of capital switching from debt to equity is approximately $9.0 billion * 0.06 (interest rate) * 0.094 (median marginal tax savings) = $50.8 million per year.[5] Approximately $5.1 million per year is attributable to NPR1, leaving $45.7 million per year as the capital cost of NPR2.

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[4] See Merton H. Miller, (1995), "Do the M & M propositions apply to banks?" *Journal of Banking & Finance*, Vol. 19, pp. 483-489.

[5] See John R. Graham, (2000), "How Big Are the Tax Benefits of Debt?" *Journal of Finance*, Vol. 55, No. 5, pp. 1901-1941. Graham points out that ignoring the offsetting effects of personal taxes would increase the median marginal tax rate to $31.5 per $100 of interest.

Table 4. – Cumulative Number of OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements and Estimated Risk-weighted Assets, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	7	12	15	16	32			
	FCPSIs	8	12	12	14	22			
	Total	15	24	27	30	54			
Tier 1 to Risk-Weighted Assets	NBOs	11	12	22	26	53			
	FCPSIs	11	13	18	18	33			
	Total	22	25	40	44	86			
Minimum Total Capital + Conservation Buffer	NBOs	30				34	47	82	130
	FCPSIs	26				28	37	51	60
	Total	56				62	84	133	190
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

Table 5. – Capital Shortfall for Scheduled Minimum Capital Requirements and Estimated Risk-weighted Assets, ($ in millions) December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$17	$59	$96	$186	$924			
	FCPSIs	$51	$106	$127	$148	$288			
	Total	$68	$165	$223	$334	$1212			
Tier 1 to Risk-Weighted Assets	NBOs	$41	$59	$107	$142	$26,192			
	FCPSIs	$70	$85	$144	$180	$490			
	Total	$111	$144	$251	$322	$26,682			
Minimum Total Capital + Conservation Buffer	NBOs	$437				$623	$1,172	$5,755	$24,630
	FCPSIs	$300				$417	$531	$810	$1,122
	Total	$ 737				$1040	$1,703	$6,565	$25,752
Advanced Approaches Countercyclical Buffer	NBOs								0
	FCPSIs								0
	Total								0
Advanced Approaches Leverage Ratio	NBOs							0	
	FCPSIs							0	
	Total							0	

2. Alternative Measures of Creditworthiness

The proposed rule would require institutions to (1) establish systems to determine risk weights using the alternative measures of creditworthiness described in the proposal, and (2) apply these alternative measures to the bank's assets. We believe that this element of the proposed rule will involve costs associated with gathering and updating the information necessary to calculate the relevant risk weights, establishing procedures, and maintaining the programs that perform the calculations.

In particular, the proposed rule would require institutions with assets in each affected asset category to:

1. Establish and maintain a system to apply the gross-up approach or implement the simplified supervisory formula approach (SSFA) for securitization positions.
2. Establish and maintain a system to assign risk weights to sovereign exposures.
3. Establish and maintain systems to assign risk weights to non-U.S. public sector entities, depository institutions, and other foreign positions.
4. Assign 1-4 family residential mortgage exposures to one of two categories.

Listed below are the variables banks will need to gather to calculate risk weights under the proposed rule:

Securitization Positions:

1. Weighted average risk weight of assets in the securitized pool as determined under generally applicable risk-based capital rules
2. The attachment point of the relevant tranche
3. The detachment point of the relevant tranche
4. Cumulative losses

Residential Mortgage Exposures:

1. Mortgage category 1 or 2 determination
2. Loan-to-value ratio

Sovereign Entity Debt Positions:

1. Organization for Economic Co-operation and Development Country Risk Classifications (CRC) Score

Table 6 shows our estimate of the number of hours it will take small and large institutions to perform the activities necessary to meet the requirements of the proposed rule. We base these estimates on the scope of work required by the proposed rule and the extent to which these requirements extend current business practices. We have also taken into consideration observations from comment letters regarding the burden of similar measures in a proposed amendment to the market risk rule. These observations suggest that the securitization element of the proposed rule may involve some additional data gathering before an institution is able to accurately calculate risk weights using the SSFA approach.

Although the total cost of gathering the new variables will depend on the size of the institution's portfolio, we believe that the costs of establishing systems to match creditworthiness variables with exposures and calculate the appropriate risk weight will account for most of the expenses associated with the credit rating alternatives. Once a bank establishes a system, we expect the marginal cost of calculating the risk weight for each additional asset in a particular asset class will be relatively small. We also note that it is likely that a third-party will eventually emerge to provide risk weights for these assets. Our estimates do not reflect this cost-saving innovation, however, as we cannot be sure such a provider will emerge or be retained by institutions subject to the rule.

We estimate that large financial institutions, those with assets of $10 billion or more, covered by the proposed rule will spend approximately 1,300 hours during the first year the rule is in effect. In subsequent years, we estimate that all financial institutions will spend approximately 180 hours per year on activities related to determining risk weights using the alternative measures of creditworthiness. For smaller institutions, those with total assets less than $10 billion, we estimate that they will spend approximately 425 hours during the first year the rule is in effect. Most smaller institutions do not lend to foreign governments or banks in foreign countries, and they do not hold foreign debt securities. Thus, for smaller institutions, we include system and compliance costs related to sovereign debt in the system and compliance costs for other positions.

Table 7 shows our overall cost estimate related to the determination of risk weights using the measures of creditworthiness in the proposed rule. Our estimate of the compliance cost of the proposed rule is the product of our estimate of the hours required per institution, our estimate of the number of institutions affected by the rule, and an estimate of hourly wages. To estimate hours necessary per activity, we estimate the number of employees each activity is likely to need and the number of days necessary to assess, implement, and perfect the required activity. To estimate hourly wages, we reviewed data from May 2010 for wages (by industry and occupation) from the U.S. Bureau of Labor Statistics (BLS) for depository credit intermediation (NAICS 522100). To estimate compensation costs associated with the proposed rule, we use $85 per hour, which is based on the average of the 90th percentile for seven occupations (i.e., accountants and auditors, compliance officers, financial analysts, lawyers, management occupations, software developers, and statisticians) plus an additional 33 percent to cover inflation and private sector benefits.[6] As shown in table 7, we estimate that the cost of introducing alternative measures of creditworthiness is approximately $46.5 million.

2. Disclosure Requirements

The proposed rule requires institutions with total assets of $50 billion or more to disclose information on a somewhat lengthy list of structural and financial variables. We estimate that meeting the disclosure requirements will entail approximately 520 hours during the first year the proposed rule applies, and this will cost the affected institutions approximately $44,200 in the first year. We estimate that the time necessary to meet the disclosure requirements in subsequent years will diminish substantially, to roughly 25 hours per quarter or 100 hours per year. We estimate that approximately 23 OCC-regulated institutions will be subject to the disclosure requirements in the proposed rule, resulting in a cost of $1.0 million.

3. Overall Cost Estimate for Standardized Approaches for Risk-weighted Assets

Combining our estimates of capital costs ($45.7 million), the cost of applying alternative measures of creditworthiness ($46.5 million), and disclosure requirements ($1.0 million), our overall estimate of the cost of the proposed rule (NPR2) is $93.2 million.

[6] According to the BLS' employer costs of employee benefits data, thirty percent represents the average private sector costs of employee benefits.

Table 6. Estimated Annual Hours for Creditworthiness Measurement Activities

Asset	Activity	Estimated hours per institution with total assets < $10 bil.	Estimated hours per institution with total assets ≥ $10 bil.
Securitization	System development	120	480
	Data acquisition & Due Diligence	80	240
	Calculation, verification, and training	60	120
Residential Mortgages	System development	60	60
	Data acquisition	30	50
	Calculation, verification, and training	10	10
Sovereign Debt	System development		80
	Data acquisition		30
	Calculation, verification, and training		60
Other Positions Combined[7]	System development	40	80
	Data acquisition	20	30
	Calculation, verification, and training	5	60
Total Hours		425	1,300

[7] Includes sovereign debt implementation costs for institutions with less than $10 billion in assets.

Table 7.
Estimated Costs of Creditworthiness Measurement Activities, December 31, 2011

Institution	Number of institutions	Estimated hours per institution	Estimated cost per institution	Estimated cost
Small banking organizations (assets < \$10 bil.)	1,177	425	\$36,125	\$42,519,125
Large banking organizations (assets ≥ \$10 bil.)	36	1,300	\$110,500	\$3,978,000
Total	1,213			\$46,497,125

Regulatory Flexibility Act (RFA) Analysis

As part of our analysis, we considered whether the proposed rule is likely to have a significant impact on a substantial number of small entities, pursuant to the RFA. The size threshold for small banks is \$175 million. Tables 8 and 9 show our estimates of the number and capital shortfall for small institutions under the proposed rules (NPR1 and NPR2). We estimate that the cost of lost tax benefits associated with increasing total capital by \$143 million as shown in table 9 will be approximately \$0.8 million per year. Averaged across the 56 affected institutions, the cost is approximately \$14,000 per institution per year. From table 7, we estimate that the cost of implementing the alternative measures of creditworthiness will be approximately \$36,125 per institution. For the 56 institutions with a projected capital shortfall, we estimate that the cost of the standardized approaches for risk-weighted assets will be slightly more costly at approximately \$50,000 per institution.

To determine if the proposed rule has a significant economic impact on small entities we compared the estimated annual cost with annual noninterest expense and annual salaries and employee benefits for each small entity. If the estimated annual cost was greater than or equal to 2.5 percent of total noninterest expense or 5 percent of annual salaries and employee benefits we classified the impact as significant. The proposed rule will have a significant economic impact on 500 small national banks and 253 small federally chartered private savings institutions. Accordingly, the proposed rule appears to have a significant economic impact on a substantial number of small entities.

Table 8. – Cumulative Number of Small OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements and Estimated Risk-weighted Assets, December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	6	8	9	10	16			
	FCPSIs	2	3	3	3	7			
	Total	8	11	12	13	23			
Tier 1 to Risk-Weighted Assets	NBOs	7	8	11	13	22			
	FCPSIs	3	3	5	5	13			
	Total	10	11	16	18	35			
Minimum Total Capital + Conservation Buffer	NBOs	15				17	22	27	37
	FCPSIs	10				11	13	17	19
	Total	25				28	35	44	56

Table 9. – Capital Shortfall for Small OCC-Regulated Banking Organizations for Scheduled Minimum Capital Requirements and Estimated Risk-weighted Assets, ($ in millions) December 31, 2011

		Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	NBOs	$8	$21	$25	$30	$54			
	FCPSIs	$1	$2	$3	$3	$10			
	Total	$9	$23	$28	$33	$64			
Tier 1 to Risk-Weighted Assets	NBOs	$25	$29	$39	$45	$75			
	FCPSIs	$1	$2	$4	$5	$16			
	Total	$26	$31	$43	$50	$91			
Minimum Total Capital + Conservation Buffer	NBOs	$58				$67	$76	$94	$111
	FCPSIs	$9				$13	$17	$25	$32
	Total	$67				$80	$93	$119	$143

MEMORANDUM

Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

To: Carl Kaminski, Legislative and Regulatory Activities

Thru: Gary Whalen, Director, Policy Analysis Division

From: Douglas Robertson, Senior Financial Economist, Policy Analysis Division

Date: May 30, 2012

Subject: Impact Assessment for the Basel III Rule: Advanced Approaches, NPR3

This memorandum provides our assessment of the economic impact of the proposed rules that would implement the Basel III framework developed by the Basel Committee on Banking Supervision. The Basel III framework would revise current general risk-based capital rules and would be applicable to all banking organizations. The federal banking agencies are implementing Basel III through three separate rules. The first rule would apply Basel III minimum capital requirements to all banking organizations (NPR1). The second rule would implement new alternative measures of creditworthiness for all banking organizations (NPR2).[1] The third rule would apply Basel III enhancements to the risk-weighted assets of institutions subject to the advanced approaches capital rules (NPR3). Advanced approaches banking organizations are those institutions with total assets of at least $250 billion or foreign exposures of at least $10 billion, or institutions that have elected to adopt the advanced approaches.

1) Basel III NPR (NPR1)
This will include the changes to the numerator of the risk-based capital ratio, the new ratio requirements (common equity Tier 1 and the higher minimums), as well as the conservation and countercyclical buffers. It also will include the changes to the treatment of mortgage servicing assets and deferred tax assets (DTAs).

2) Standardized Approach NPR (NPR2)
This will include the changes to the calculation of risk-weighted assets (the denominator of the risk-based capital ratio), except for the treatment of mortgage servicing assets and DTAs discussed in the Basel III NPR.

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[1] These rules would serve as the generally applicable capital rules and therefore would be a floor for the risk-based capital requirement for advanced approaches banks under Section 171 of the Dodd Frank Act.

3) Advanced Approaches NPR (NPR3)
The advanced approaches NPR will introduce enhancements to the advanced approaches rule, and it will include a proposal to expand the scope of the market risk rule to include thrifts.

We estimate that the first-year cost associated with higher minimum capital requirements in NPR1 will be approximately $5.1 million. We estimate that the first-year cost associated with changes in risk-weighted assets and implementation of alternative measures of creditworthiness in NPR2 will be approximately $93.2 million. We estimate that the first-year cost associated with changes in risk-weighted assets and simultaneously meeting new market risk capital requirements in NPR3 will be approximately $46.8 million. Together, we estimate that the overall cost of the three Basel III rules will be approximately $145.1 million in the first year. After introducing new systems for determining risk weighted assets in the first year, we estimate that the overall cost of Basel III in subsequent years will decrease to approximately $98.6 million per year.

I. <u>The Proposed Rule: Advanced Approaches Risk-based Capital (NPR3)</u>

The proposed rule would incorporate Basel Committee on Bank Supervision revisions to the Basel capital framework into the banking agencies' advanced approaches capital rules and remove references to credit ratings consistent with section 939A of the Dodd-Frank Act. The proposed rule would apply the market risk capital rule to certain savings associations.

The proposed rule would modify various elements of the advanced approached risk-based capital rules regarding the determination of risk-weighted assets. These changes would (1) modify treatment of counterparty credit risk, (2) remove references to credit ratings, (3) modify the treatment of securitization exposures, and (4) modify the treatment of exposures subject to deduction from capital. The proposed rule would also enhance disclosure requirements, especially with regard to securitizations.

The proposed rule would amend the advanced approaches so that capital requirements using the internal models methodology takes into consideration stress in calibration data, stress testing, initial validation, collateral management, and annual model review. The proposed rule would also require a banking organization to identify, monitor, and control wrong-way risk, which the proposed rule defines as the risk that arises when an exposure to a particular counterparty is positively correlated with the probability of default of such counterparty itself.

The proposed rule would also remove the ratings-based approach and the internal assessment approach for securitization exposures from the advanced approaches rule and require advanced approaches banking organizations to use either the supervisory formula approach (SFA) or a simplified version of the SFA when calculating capital requirements for securitization exposures.

Advanced approaches banking organizations would be required to calculate their risk-based and leverage capital requirements under the standardized approach (using the numerator and denominator in NPR 1 and NPR 2), as well as the under the revised advanced approaches, outlined in this proposal (NPR 3). Advanced approaches banking organizations would apply the lower risk-based capital and leverage ratios for purposes of determining compliance with the proposed minimum regulatory capital requirements.

II. Institutions Affected By the Proposed Rule

The proposed rule (NPR3) will apply to advanced approaches banking organizations, i.e., banking organizations with total assets of at least $250 billion or foreign exposures of at least $10 billion, other banking organizations that have elected to adopt the advanced approaches, and banking organizations that are subsidiaries of banking organizations that must use the advanced approaches rules. The NPR also proposes to expand the scope of the market risk rule to apply to savings associations and savings and loan holding companies that meet the relevant trading activity thresholds – $1 billion or more in trading activity or trading activity equal to 10 percent or more of the banking organization's total assets.

III. Estimated Costs and Benefits of the Proposed Rule

Benefits of the Proposed Rule

The proposed rule would produce the following benefits:
1. Increases risk sensitivity of risk-weighted assets
2. Improves transparency and market discipline through disclosure requirements.
3. Enhances counterparty credit risk capital requirements that proved inadequate during the financial crisis

Costs of the Proposed Rule

1. Impact of Risk-weighted Assets on Capital Requirements

The modifications to risk-weighted assets in the proposed rule will affect overall risk-weighted assets and hence risk-based capital ratios for advanced approaches banks. Applying new risk weights implies that capital requirements may go down for some assets and up for others. As with NPR2, securitization exposures in particular may face higher capital charges under the proposed rule.

As with NPR2, we estimate the proposed rule's impact on risk-weighted assets by applying the average change in risk-weighted assets reported by the Basel Committee on Banking Supervision quantitative impact study working group. For the analysis of NPR3, we first estimate the effect of increasing risk-weighted assets of advanced approaches banks by 20 percent. We also incorporate estimates of the effect of the market risk rule on institutions that are subject to both the advanced approaches rule and the market risk rule.

To estimate the impact of the proposed rule (NPR3) on bank capital needs, we estimate the amount of capital banks will need to gather to meet the new minimum standards described in our analyses of NPR1 and NPR2. As with those analyses, we estimate new capital ratios and requirements by combining various Call Report items to reflect definitional changes to common equity capital, Tier 1 capital, and total capital as described in NPR1. We also increase current risk-weighted assets by 20 percent as described in NPR2.

We thus construct new capital ratios for advanced approaches banking organizations reflecting the requirements of the proposed rules (NPR1 and NPR2) and estimate capital shortfalls as the difference between current capital levels and capital levels necessary to meet the new minimum standards. We estimate the capital shortfall each institution would encounter as the new capital ratios come into effect during the transition period from 2013 through 2019. Table 1 shows our estimates of the number of advanced approaches institutions that would not meet the transition schedule for proposed minimum capital requirements using data as of December 31, 2011. Table 2 shows our estimates of the aggregate amount of capital shortfall over the transition period ending in 2019. While institutions must simultaneously meet all of the minimum capital requirements, the largest shortfall amount in any given year shows the most binding minimum capital requirement. The number of institutions and the capital shortfall amounts shown in the 2016 column reflect those institutions that show a shortfall with regard to the new PCA standards relative to current capital levels.

Table 2 shows that $22 billion of our NPR2 estimate of a $27 billion capital shortfall is attributable to 3 advanced approaches banks that would encounter a capital shortfall in 2015 when the new Tier 1 PCA standard for well-capitalized institutions takes effect.

Because many advanced approaches banks are also subject to the market risk rule, we repeat our capital shortfall estimate by adding estimated market risk assets to the capital ratios for these institutions. Table 3 shows our estimate of the number of institutions that would need to increase capital levels to meet new minimum capital requirements. Table 4 shows our estimate of the amount of capital needed to meet those capital requirements.

We assume that the aggregate cost of increasing capital will be spread out over several years. Table 2 reflects capital amounts already included in our analysis of NPR2. To estimate the amount of required capital not accounted for in NPR2, we subtract the capital amounts shown in table 2 from those shown in table 4. This comparison suggests that the earliest significant capital requirement for advanced approaches banks will be raising $24.8 billion in capital to meet the new PCA Tier 1 standard for well-capitalized institutions when it takes effect. We estimate that the largest shortfall for any given year will be approximately $8.3 billion, or one third of the amount needed to meet this new PCA Tier 1 standard.

To estimate the cost to banks of the new capital requirement, we examine the effect of this requirement on capital structure and the overall cost of capital.[2] As with our estimates in NPR1 and NPR2, we estimate that the cost of the increase in capital would be tax benefits foregone: the capital requirement ($8.3 billion), multiplied by the interest rate on the debt displaced and by the effective marginal tax rate for the banks affected by the proposed rule. Graham (2000) estimates a median marginal tax benefit of $9.40 per $100 of interest. So, using an estimated interest rate on

[2] See Merton H. Miller, (1995), "Do the M & M propositions apply to banks?" *Journal of Banking & Finance*, Vol. 19, pp. 483-489.

debt of 6 percent, we estimate that the annual tax benefits foregone on $8.3 billion of capital switching from debt to equity is approximately $8.3 billion * 0.06 (interest rate) * 0.094 (median marginal tax savings) = $46.8 million per year.[3]

Table 1. – Cumulative Number of OCC-Regulated Advanced Approaches Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements and Estimated Risk-weighted Assets, December 31, 2011

	Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	0	0			
Tier 1 to Risk-Weighted Assets	0	0	0	0	3			
Minimum Total Capital + Conservation Buffer	0				0	0	1	3
Advanced Approaches Countercyclical Buffer								1
Advanced Approaches Leverage Ratio							0	

[3] See John R. Graham, (2000), "How Big Are the Tax Benefits of Debt?" *Journal of Finance,* Vol. 55, No. 5, pp. 1901-1941. Graham points out that ignoring the offsetting effects of personal taxes would increase the median marginal tax rate to $31.5 per $100 of interest.

Table 2. – OCC-Regulated Advanced Approaches Banking Organizations Cumulative Capital Shortfall for Scheduled Minimum Capital Requirements and Estimated Risk-weighted Assets, ($ in millions) December 31, 2011

	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	0			
Tier 1 to Risk-Weighted Assets	0	0	0	$22,175			
Minimum Total Capital + Conservation Buffer				0	0	$2,501	$18,586
Advanced Approaches Countercyclical Buffer							$3,918
Advanced Approaches Leverage Ratio						0	

Table 3. – Cumulative Number of OCC-Regulated Advanced Approaches Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements Including Estimated Risk-weighted & Market Risk Assets, December 31, 2011

	Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	0	1			
Tier 1 to Risk-Weighted Assets	0	0	0	1	3			
Minimum Total Capital + Conservation Buffer	0				1	1	2	4
Advanced Approaches Countercyclical Buffer								1
Advanced Approaches Leverage Ratio							0	

Table 4. – OCC-Regulated Advanced Approaches Banking Organizations Cumulative Capital Shortfall for Scheduled Minimum Capital Requirements Including Estimated Risk-weighted & Market Risk Assets, ($ in millions) December 31, 2011

	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016 (PCA)	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
Common Equity to Risk-Weighted Assets	0	0	0	$15,061			
Tier 1 to Risk-Weighted Assets	0	0	$6,689	$46,937			
Minimum Total Capital + Conservation Buffer				$9,101	$17,473	$31,516	$57,430
Advanced Approaches Countercyclical Buffer							$23,432
Advanced Approaches Leverage Ratio						0	

2. Cost of Disclosure Requirements

The proposed rule requires advanced approaches banking organizations to amend disclosures regarding securitizations to include the following:

- The nature of the risks inherent in a banking organization's securitized assets,
- A description of the bank's policies for monitoring changes in the credit and market risk of the organization's securitization exposures,
- A description of a banking organization's policy regarding the use of credit risk mitigation for securitization exposures,
- A list of the special purpose entities a banking organization uses to securitize exposures and the affiliated entities that a bank manages or advises and that invest in securitization exposures or the referenced SPEs, and
- A summary of the banking organization's accounting policies for securitization activities.

As described in our analysis of NPR2, we estimate that meeting all disclosure requirements will entail approximately 520 hours during the first year the proposed rule applies, and this will cost the affected institutions approximately $44,200 in the first year. We estimate that the time necessary to meet the disclosure requirements in subsequent years will diminish substantially, to roughly 25 hours per quarter or 100 hours per year.

Because we included these disclosure costs along with system implementation costs in our analysis of NPR2, we do not include these expenses in this analysis. Thus, our overall estimate of the cost of the proposed rule (NPR3) is $46.8 million per year. This cost estimate reflects the added capital burden of institutions that will be subject to both the advanced approaches capital rules and the revised market risk rule.

Regulatory Flexibility Act (RFA) Analysis

The proposed rule (NPR3) will apply to advanced approaches banking organizations, i.e., banking organizations with total assets of at least $250 billion or foreign exposures of at least $10 billion, other banking organizations that have elected to adopt the advanced approaches, and banking organizations that are subsidiaries of banking organizations that must use the advanced approaches rules. Our size threshold for small banks for RFA purposes is $175 million in assets. The proposed rule will affect six small subsidiaries of advanced approaches organizations. We do not consider this a substantial number of small institutions, and thus we believe that the proposed rule will not have a significant effect on a substantial number of small entities.

PREPARED STATEMENT OF GEORGE FRENCH

DEPUTY DIRECTOR, POLICY, DIVISION OF RISK MANAGEMENT SUPERVISION, FEDERAL DEPOSIT INSURANCE CORPORATION

NOVEMBER 14, 2012

Chairman Johnson, Ranking Member Shelby, and Members of the Committee, thank you for the opportunity to testify today on behalf of the Federal Deposit Insurance Corporation (FDIC) regarding the recently proposed changes to the Federal banking agencies' regulatory capital requirements. The FDIC has had a long-standing concern for stronger bank capital requirements, and we welcome the opportunity to discuss these important proposals. The Federal banking agencies have received and are carefully reviewing a significant number of comments on these proposals.

Background

As you know, in June of this year, the Federal banking agencies issued for public comment three separate Notices of Proposed Rulemaking, or NPRs, proposing changes to the regulatory capital requirements. Two of the NPRs would implement the recent Basel III standards developed by the Basel Committee on Banking Supervision and update our regulations in conformity with Section 939A of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The first of these, the Basel III NPR, would strengthen the quality of bank capital and increase its required level for all institutions, including community banks. The Basel III NPR also includes selected Basel III capital requirements applicable only to banking organizations that use the agencies' Advanced Approaches capital regulation. The second NPR, the Advanced Approaches NPR, proposes additional requirements from the Basel III agreement and other Basel standards for these large Advanced Approaches organizations. The third NPR, referred to as the Standardized Approach NPR, proposes changes to the risk-weighting of assets and replaces credit ratings in the agencies' capital regulations in accordance with Section 939A of the Dodd-Frank Act. This NPR would apply to all institutions. The comment period on all three NPRs closed on October 22, 2012. Also, in June of this year, the agencies finalized regulations that change the way banks with a large volume of trading activity calculate capital requirements for market risk.

The agencies proposed the NPRs to address deficiencies in bank capital requirements that became evident in the recent banking crisis. A number of banking organizations failed or required Federal assistance during the crisis, and the U.S. Government provided capital, liquidity and guarantees to a significant portion of the financial sector, including depository institution holding companies and their affiliates. Since January 1, 2008, 463 FDIC-insured banks have failed.

In light of this experience, strengthening bank capital requirements seems to be an appropriate and important step. All banks need strong capital to navigate periods of economic turbulence while continuing to serve their important role as financial intermediaries to the economy. The changes proposed in the NPRs are intended to address identified deficiencies in the existing capital regime and provide greater comfort in the capital adequacy of our banking system. At the same time, reviewing the numerous comments received will help us address concerns about the costs and potential unintended consequences of various aspects of the proposals.

My testimony will describe the proposed rules in more detail, along with some of the most frequently identified concerns among the more than 1,500 comments we have received. It is worth emphasizing that the rulemaking process is ongoing and the agencies have not yet reached final decisions regarding how to address the various issues that have been raised with respect to the NPRs.

The Basel III NPR

One of the critical lessons learned from the recent financial crisis was that high-quality, loss-absorbing capital is essential to ensuring the safety and soundness of financial institutions. As such, in the aftermath of the crisis, the FDIC and the other U.S. banking agencies participated in an intensive international effort to strengthen bank capital standards. The result of these efforts is the Basel III capital agreement. In broad terms, the Basel III capital standards aim to improve the quality and increase the required level of bank capital. Collectively, Basel III and other standards published by the Basel Committee address a number of features of capital regulation that allowed for an excessive use of leverage in the years leading up to the crisis.

The FDIC Board of Directors voted to issue the Basel III NPR for public comment on June 12, 2012. The Basel III NPR proposes to strengthen the definition of regulatory capital to better absorb losses than under current rules, and to increase the required level of capital. These changes are proposed to be phased in over time. The NPR also includes selected requirements that apply only to banks using the agencies' Advanced Approaches capital regulation.

The Basel III NPR proposes a number of changes to strengthen the definition of capital. The most important of these changes are described below.

- Under current rules, common equity is permitted to comprise as little as half of Tier 1 capital, reducing the loss absorbency of, and market confidence in, the regulatory capital measure. The Basel III NPR proposes a new risk-based capital requirement for "common equity Tier 1," a form of regulatory capital that would be more reliably available to absorb losses.
- Intangible assets, except for a limited amount of mortgage servicing rights, are deducted from capital in the Basel III NPR. Intangible assets, which are generally difficult to sell in order to absorb losses, are subject to limits in current capital rules, but the NPR makes these limits more stringent.
- Deferred tax assets are subject to stricter limits in the Basel III NPR. These assets, as analysts noted during the crisis, may have little value when a bank is losing money and capital support is most needed.
- Investments in the capital instruments of other financial institutions that exceed specified thresholds are deducted from capital in the Basel III NPR. It was evident in the recent crisis that inclusion of large amounts of such investments in a banking organization's capital can create a chain of interconnected losses that exacerbates a banking crisis.
- Minority interests in consolidated subsidiaries are subject to stricter limits in the Basel III NPR. Minority interests can absorb losses in a specific subsidiary but may be unavailable to absorb losses throughout an organization.
- Trust Preferred Securities (TruPS) are subject to a phase-out from Bank Holding Companies' (BHC5) Tier 1 capital in the Basel III NPR (a 3-year phase-out for large BHCs and a 10-year phase-out for smaller BHCs). TruPS can absorb losses in a failure, but do not absorb losses on a going-concern basis. The application of this proposed change to smaller BHCs, and the change to the treatment of accumulated other comprehensive income described below, have been frequent subjects of concern from commenters.
- Accumulated other comprehensive income (AOCI), which includes unrealized gains and losses on available-for-sale (AFS) securities, is proposed to be included in the calculation of capital under the Basel III NPR.[1] Incorporating these gains and losses as proposed in the NPR may result in a better indicator of the bank's capital strength if it is forced to sell these securities in an adverse economic environment.

We are carefully considering the comments we have received on each of these proposed changes to the definition of capital.

As noted above, the Basel III NPR proposes to establish a new risk-based capital requirement for "common equity Tier 1" capital. Under the NPR, banks would need to hold common equity Tier 1 capital in an amount that is at least 4.5 percent of risk-weighted assets in order to be considered "Adequately Capitalized." The NPR also proposes to increase by two percentage points the minimum and "Well Capitalized" levels for the Tier 1 risk-based capital ratios that are part of the agencies' Prompt Corrective Action (PCA) regulations.

The Basel III NPR also proposes a capital buffer incorporating a sliding scale of dividend restrictions for banks whose risk-based capital ratios are less than 2.5 percentage points higher than the regulatory minimums. The purpose of the buffer is to encourage banks to maintain a cushion of capital above the regulatory minimums so they will be able to continue to lend during periods of economic adversity without breaching those minimums. The Basel III buffer is similar to the statutory requirement that the agencies' PCA regulations include a capital ratio threshold for banks to be considered "Well Capitalized."

In addition, the Basel III NPR requires banks that use the Advanced Approaches capital regulation to comply with a supplementary leverage ratio that includes certain off-balance sheet items in the denominator. The FDIC views the leverage ratio as a foundational measure of capital, and we are highly supportive of its inclusion in the Basel framework. The complexities specific to the Basel III leverage ratio,

[1] Under existing regulations, unrealized gains and losses on AFS debt securities are not included in regulatory Tier 1 capital. Unrealized losses on AFS equity securities with readily determinable fair value are included in Tier 1 capital, while a portion of unrealized gains on AFS equity securities can be included in Tier 2 capital.

however, are mainly relevant for very large institutions with extensive off-balance sheet activities. For that reason, the agencies have proposed that the Basel III leverage ratio would be a supplementary requirement, and only applied to banks using the Advanced Approaches capital regulation. The existing U.S. leverage ratio requirements would remain in effect for all U.S. banks.

The Basel III NPR also requires Advanced Approach banking organizations to hold additional capital in the form of a "countercyclical buffer" if the agencies determine that the banking industry is experiencing excessive credit growth. The NPR indicated that the countercyclical buffer initially would be set at zero, with the agencies acting jointly to raise that level, if and when credit conditions warranted putting this buffer into effect. If a determination was made that the buffer was necessary, the amount of the buffer could be as much as 2.5 percent of risk-weighted assets. The countercyclical buffer would serve to provide additional capital for the losses that often follow a period of excessive credit growth, and may itself serve as a check on excessive growth. Again, the NPR indicates that the countercyclical buffer would only be in effect when credit conditions warrant and would be zero at other times.

The minimum capital ratios and capital buffers proposed in the Basel III NPR were developed as part of a Basel Committee effort, in which the agencies participated, to estimate the amount of bank capital needed to absorb losses in severe economic scenarios including the losses experienced in banking crises in different countries over time. The results of this analysis were published in October, 2010. [2] The results suggest that bank capital ratios at the levels agreed to by the Basel Committee and proposed in the Basel III NPR would provide reasonable assurance that banks would be able to absorb losses during a period of economic adversity while continuing to be able to lend—and certainly greater assurance than exists under the current rules.

While working as part of the Basel Committee to develop the capital ratios that were proposed in the Basel III NPR, the agencies were mindful that while the requirements should be sufficient to enable banks to withstand a period of economic adversity, they should not be so high as to choke off prudent lending or normal economic activity. The agencies participated in international efforts to evaluate the potential effect of the higher bank capital requirements on economic activity. This work focused on two issues. One issue is the potential costs to the broader economy of an insufficiently capitalized banking system. Experience suggests that banking crises have consistently been followed by large and long-lasting reductions in economic activity. The other—and competing issue—is the costs that higher capital requirements might impose by increasing the cost of credit and reducing the volume of lending.

The literature reviews and other analysis conducted as part of these international efforts generally concluded that within the range of capital requirements being considered, the economic benefits of higher capital requirements from reducing the frequency and severity of banking crises would exceed the economic costs resulting from a modest increase in the cost of credit. [3] This analysis supports the overall conclusion that an increase in bank capital requirements from current levels is warranted. Precrisis increases in leverage permitted by the current capital rules did stimulate financial institution growth and earnings for a time, but the real economy ultimately suffered a significant cost when the financial cycle turned. In addition to the financial institution failures and Government assistance mentioned earlier in this testimony, the U.S. economy experienced a loss of over eight and a half million payroll jobs as a result of the recession, and it suffered a 35 percent decline in home prices as well as over 10 million new foreclosures. The decline in employment and economic activity reduced revenues at all levels of Government, with fiscal effects that reverberate back to the real economy.

While we view strengthening bank capital requirements as an appropriate goal to reduce the likelihood and severity of future banking crises, the agencies also are mindful that the proposals in these three NPRs represent significant change. The review of comments that is now underway is expected to shed considerable light on

[2] "Calibrating Regulatory Minimum Capital Requirements and Capital Buffers: A Top–Down Approach", October, 2010, Basel Committee on Bank Supervision; *http://www.bis.org/publ/bcbs180.htm.*

[3] "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements", August, 2010; Basel Committee on Bank Supervision; http://www.bis.org/publ/bcbsl73.htm, and "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements (MAG Analysis)," December, 2010, Financial Stability Board and Basel Committee on Bank Supervision; *http://www.bis.org/publ/othp12.pdf.*

the potential for unintended consequences associated with specific aspects of these proposals.

Advanced Approaches NPR

In addition to the Basel III NPR, the FDIC Board of Directors approved a separate NPR on June 12 that proposes a number of enhancements to the calculation of risk-weighted assets for the large, complex banks using the Advanced Approaches. This NPR proposes to implement aspects of Basel III that are designed to improve and strengthen modeling standards, the treatment of counterparty credit risk, credit risks associated with securitization exposures, and disclosure requirements. The proposal also contains alternatives to credit ratings consistent with Section 939A of the Dodd-Frank Act. The proposals in this NPR would strengthen the existing Advanced Approaches capital rules, particularly those related to capital requirements for derivatives.

The FDIC has had a longstanding concern about the reliance in the Advanced Approaches rule on a bank's own models and risk estimates. Section 171 of the Dodd-Frank Act (the Collins Amendment) addresses this concern by placing a floor under the Advanced Approaches capital requirements that ensures that the Advanced Approaches capital requirements are not less than the requirements that are generally applicable to other banks.

Standardized Approach NPR

The third NPR, the Standardized Approach proposal, includes a number of proposed changes to the calculation of risk-weighted assets in the agencies' general risk-based capital rules. The proposal also includes alternatives to credit ratings consistent with Section 939A of the Dodd-Frank Act. The capital requirements proposed in the Standardized Approach NPR are separate and distinct from those under the Basel III framework.

The Standardized Approach proposal was designed to address shortcomings in the measurement of risk-weighted assets that became apparent during the recent financial crisis. In part, this is addressed by implementing certain changes based on the Basel II Standardized Approach contained in the Basel international regulatory capital standards and by replacing credit ratings consistent with section 939A of the Dodd-Frank Act. The proposed risk-weightings and segmentation methodologies for residential mortgages were developed by the Federal banking agencies in response to issues observed during the financial crisis. Among other things, the proposed rule would:

- revise risk weights for residential mortgages based on loan-to-value ratios and certain product and underwriting features;
- increase capital requirements for past-due loans, high volatility commercial real estate exposures, and certain short-term loan commitments;
- expand the recognition of collateral and guarantors in determining risk-weighted assets;
- remove references to credit ratings; and
- establish due-diligence requirements for securitization exposures.

We have estimated that the large majority of insured banks would meet the capital requirements resulting from the combined implementation of the Basel III NPR and the Standardized Approach NPR. The attachment to this testimony describes the methodology for these estimates and the results for banks in different size groups. These estimates suggest that for most insured banks, the proposals would not result in a need to raise new capital. It should be emphasized that these are estimates, and that institutions themselves will have better information about the specific factors used in the proposed capital calculations than the agencies currently collect in financial reports. In particular, our estimates did not attempt to address the extent to which institutions might feel the need to hold additional capital buffers beyond those specifically proposed, for example, to offset future changes in AOCI. Our review of the public comments is expected to shed additional light on such issues.

Final Market Risk Rule

On June 12, the FDIC Board of Directors also approved the final regulation making improvements to the Market Risk Rule. This final regulation, which takes effect on January 1, 2013, addresses important weaknesses of the current Market Risk Rule to reflect lessons learned in the financial crisis. Leading up to the crisis, low capital requirements under the current Market Risk Rule encouraged institutions to place illiquid, high-risk assets in their trading books. Large mark-to-market losses on these assets played an important role in fueling the financial crisis during its early stages. The final regulation requires an appropriate increase in the stringency of the Market Risk Rule that will better address such risks.

This final rule applies only to the largest institutions that have significant trading activities. It is based on reforms that were agreed to internationally with the Basel Committee's 2009 revisions to the Basel II market risk framework. These revisions are part of what is generally referred to as the Basel II.5 reforms.

Concerns have been expressed that the Market Risk Rule, while improved, is still too reliant on internal models. The idea of establishing a simple, nonmodeled and higher minimum capital floor for all trading book capital requirements is worthy of further study, and is in fact being considered as part of a fundamental review of trading book capital requirements being conducted by the Basel Committee.

Outreach and Comments

As the primary Federal supervisor for the majority of community banks, the FDIC is particularly focused on ensuring that community banks are able to properly analyze the capital proposals and assess their impact. Since the Basel III NPR and the Standardized Approach NPR would affect all banks, the FDIC undertook an outreach agenda to assist community banks in analyzing the impact of the proposals.

First, both the Basel III NPR and the Standardized Approach NPR contain a relatively short and concise addendum designed to aid smaller banks in identifying and understanding the aspects of the proposal that would apply to them.

Second, FDIC staff hosted six community bank capital outreach sessions, one in each of the FDIC regional offices. Each session included an FDIC staff overview of the NPRs that identified the most significant changes for community banking organizations, and a question-and-answer session for the bankers in attendance.

Third, the FDIC posted an on-demand video on its Web site that contains the same information provided by the FDIC in the live outreach sessions. Copies of the materials provided to bankers at the live outreach sessions are also posted online.

Fourth, FDIC staff hosted a national call to address the questions most frequently asked by attendees at the live outreach program sessions.

Finally, the FDIC, along with the other banking agencies, developed a Regulatory Capital Estimation Tool designed to assist community banking organizations and other interested parties in evaluating the potential effect that the Basel III NPR and the Standardized Approach NPR could have on their capital ratios.

We believe that these outreach efforts have helped many bankers understand these proposals and identify the issues that are of concern to them. As of November 8, the FDIC had received more than 1500 comments. The vast majority of these comments are from community banks. Their comments have been highly substantive and provide significant information regarding the possible impact of the proposals.

The FDIC is in the process of reviewing all of the comments received. To date, many commenters have raised concerns about the generally higher level of capital requirements for community banks. A number of commenters have requested that the agencies not apply the Basel III or Standardized Approach NPRs to community banks. Some commenters have requested that the agencies withdraw the Standardized Approach NPR.

In addition to these general comments, a few more specific topics have been mentioned quite frequently. First, many commenters have expressed concern that the Basel III NPR proposes to include AOCI in the calculation of regulatory capital, thereby including gains and losses on available-for-sale debt securities. These commenters believe that the inclusion of AOCI will increase the volatility of regulatory capital, forcing banks to hold additional capital buffers, and complicate their ability to manage interest rate risk and comply with legal lending limits. Also with respect to the Basel III NPR, many commenters have expressed concern that trust preferred securities issued before May 19, 2010, by community bank holding companies with less than $15 billion in assets are proposed to be phased out of Tier 1 capital.

With respect to the Standardized Approach NPR, many commenters have expressed concern about the increased complexity and systems costs of the proposed new methods for asset risk weighting, as well as the proposed increase in risk weight for certain exposures, particularly past due exposures and residential mortgages. Many community bank commenters have indicated that the proposed risk-weightings for residential mortgages will force them to curtail or exit residential mortgage lending because of what they view as the excessively high level of some of these risk weights. Commenters also express concern about how the new risk weights might interact with a number of pending mortgage regulations whose final form remains uncertain.

Conclusion

In conclusion, along with our fellow regulators, the FDIC is carefully reviewing the comments we have received regarding the NPRs. These are proposed rules and we expect to make changes based on the comments. The basic purpose of the Basel III framework is to strengthen the long-term quality and quantity of the capital base of the U.S. banking system. In light of the recent financial crisis, that would appear to be an appropriate and important goal. However, that goal should be achieved in a way that is responsive to the concerns expressed by community banks about the potential for unintended consequences.

Bank Impact Analysis
Impact of: Basel 3 with Standardized approach

in thousands	Current Data			Estimated Basel III Capital		
Bank Size	Count of Banks	Tier 1 Capital ($000)	Total Risk-Based Capital ($000)	Common Equity Tier 1 Capital	Tier 1 Capital ($000)	Total Risk-Based Capital ($000)
greater than $250B	6	$ 493,639,368	$ 615,172,789	$ 483,801,991	$ 484,301,991	$ 606,925,348
$100B - 250B	13	$ 182,216,148	$ 211,616,800	$ 175,318,671	$ 175,318,746	$ 204,621,117
$10 - 100B	89	$ 269,843,538	$ 305,163,612	$ 262,137,865	$ 264,856,372	$ 300,202,812
$1 - 10B	555	$ 145,674,132	$ 157,527,571	$ 143,362,961	$ 144,923,461	$ 156,700,358
$250m to $1B	1,900	$ 88,907,975	$ 96,142,159	$ 89,506,338	$ 90,226,284	$ 97,385,922
less than $250m	4,767	$ 55,600,188	$ 59,404,342	$ 56,526,743	$ 56,960,126	$ 60,768,936
Grand Total	7,330	$ 1,235,881,349	$ 1,445,027,273	$ 1,210,654,569	$ 1,216,586,980	$ 1,426,604,493

Additional capital required to meet alternative capital standards:

in thousands	Minimum required (adequately capitalized):			Well Capitalized			Minimum required plus CCB:		
Bank Size	Common Equity T1 RBC (4.5%)	Tier 1 RBC (6.0%)	Total RBC ratio (8.0%)	Common Equity T1 RBC (6.5%)	Tier 1 RBC (8.0%)	Total RBC ratio (10.0%)	Common Equity T1 RBC (7.0%)	Tier 1 RBC (8.5%)	Total RBC ratio (10.5%)
greater than $250B	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ 43,426	$ -
$100B - 250B	$ -	$ -	$ -	$ -	$ 257,639	$ -	$ -	$ 768,128	$ -
$10 - 100B	$ 2,407	$ 76,240	$ 230,110	$ 314,104	$ 1,162,912	$ 906,847	$ 412,536	$ 2,009,691	$ 1,727,627
$1 - 10B	$ 25,296	$ 28,301	$ 64,113	$ 56,659	$ 166,648	$ 417,516	$ 73,909	$ 304,808	$ 796,817
$250m to $1B	$ 90,087	$ 38,575	$ 48,874	$ 154,998	$ 113,225	$ 236,187	$ 179,015	$ 183,454	$ 406,942
less than $250m	$ 42,629	$ 37,550	$ 40,868	$ 54,898	$ 50,490	$ 90,776	$ 62,058	$ 63,821	$ 148,719
Grand Total	$ 160,419	$ 180,667	$ 383,965	$ 580,659	$ 1,750,915	$ 1,651,326	$ 727,518	$ 3,373,330	$ 3,080,105

Count of banks that fail to meet following capital standards:*

	Minimum required (adequately capitalized):			Well Capitalized			Minimum required plus CCB:		
Bank Size	CET1 RBC (4.5%)	Tier 1 RBC (6.0%)	Total RBC ratio (8.0%)	CET1 RBC (6.5%)	Tier 1 RBC (8.0%)	Total RBC ratio (10.0%)	CET1 RBC (7%)	Tier 1 RBC (8.5%)	Total RBC ratio (10.5%)
greater than $250B	-	-	-	-	-	-	-	1	-
$100B - 250B	-	-	-	-	1	-	-	1	-
$10 - 100B	1	1	2	2	5	5	2	7	12
$1 - 10B	2	2	3	2	9	25	3	16	42
$250m to $1B	7	5	7	12	23	62	17	41	107
less than $250m	7	5	6	14	21	83	21	45	159
Grand Total	17	13	18	30	59	175	43	111	320

Source: Call report data (3.31.12) and FDIC estimates
*** Count of banks that fail to meet the Basel III and Standardized Approach capital standards do not include approximately 233 banks that do not meet the current RBC standards.**

Abbrevaitions:
RBC = Risk Based Capital
CCB = Capital conservation buffer
CET1 = Common Equity Tier 1
B = billions
M = millions

FDIC Methodology for Estimating the Impact of the Basel III and Standardized Approach NPRs on US Banks

FDIC staff analyzed the impact of the proposed changes contained in the Basel III and Standardized Approach NPRs using Call Report data and the assumptions provided below.

Basel III (Numerator of risk-based capital ratios)
The chart below summarizes the approach and assumptions used to estimate common equity tier 1, tier 1 and total capital.

	Capital component	Call Report Line	Call Report Field	Notes and assumptions
+	Common Stock	RC-24	RCFD3230	
+	Surplus	RC-25	RCFD3839	
+	Retained Earnings	RC-26 a.	RCFD3632	
+	AOCI	RC-26 b.	RCFDB530	
+	Other Equity Capital Components	RC-26 c.	RCFDA130	
-	Goodwill & Other Intangible Assets	RC-R-7 a.	RCFDB590	
-	Change in FV of Financial Liabilities	RC-R-7 b.	RCFDF264	Deduct gains; add back losses
-	PCCR and Non-Mortgage Servicing Assets	RC-M-2 b.	RCFDB026	
-	Net deferred tax assets	RC-F-2	RCFD2148	Calculation / Assumed 40% deducted as 'carry forward' DTAs
+	Minority Interest	RC-R-6	RCFDB589	Calculation / Assumed 40% included in CET1 capital
Deductions for components exceeding 10%/15% threshold limitations				
-	Deferred Tax Assets not previously deducted	RC-F-2	RCFD2148	Calculation / Assumed 60% of DTAs related to temporary differences
-	Investments in financial institutions	RC-8	RCFD2130	Calculation / Assumed 40% of investments in FIs would be in the form of common stock
-	Mortgage servicing assets	RC-M-2.a(1)	RCFDA590	
Common Equity Tier 1 Capital				
+	Perpetual Preferred Stock & Surplus	RC-23	RCFD3838	
-	Non-Qualifying Perpetual Preferred	RC-R-5	RCFDB588	
-	Investments in unconsolidated financial institutions over threshold limits	RC-B 6.a. Col. B RC-B M6.a. Col. D RC-D 3.a	RCFDG349 RCFDG351 RCFDG299	
+	Qualifying minority interests in consolidated subs	RC-R-6	RCFDB589	Calculation / Assumed 60% included in Tier 1 capital
Tier 1 Capital				
+	Qualifying subordinated debt and redeemable preferred stock	RC-R 12	RCFD5306	
+	Non-Qualifying Perpetual Preferred	RC-R-5	RCFDB588	
+	Allowance for loan and lease losses includible in Tier 2 capital	RC-R 14	RCFD5310	
+	Other Tier 2 capital components	RC-R 16	RCFDB594	
Total Capital				

Standardized Approach (Denominator of risk-based capital ratios)
To estimate the effects of the Standardized Approach, FDIC staff started with each bank's current risk-weighted assets (RWA), as reported on the Call Report, and adjusted RWAs for asset categories where risk weights would change under the proposed rule. The chart below shows the asset categories and assumed change in risk-weights proposed under the Standardized Approach. Following the chart is a description the assumptions used in the analysis.

Asset category	Current: Appendix A RW	Projected: Standardized RW
1-4 Family Residential Loans	50%	75%
High Volatility Commercial Real Estate (HVCRE) loans	100%	150%
Non-accruing & 90 days or more past due loans	100%	150%
Intangibles (MSA, DTA not deducted in defcap)	100%	250%
Securitizations	50%	75%
Derivatives	0%/ 20%/ 50%	0%/ 4%/ 10%
Fed Funds Sold and Securities Purchased to Resell	0%/ 20%/ 100%	0%/ 8%/ 40%
Securities Lent	0%/ 20%/ 50%/ 100%	0%/ 8%/ 20%/ 40%

Assumptions:

- 1-4 Family Mortgages: FDIC staff used data from Lender Processing Services (LPS) to estimate the risk-weight on the stock of residential mortgage loans in the banking industry. LPS collects data on mortgage originations, including some mortgage loan characteristics such as loan-to-value ratios.
- High-Volatility Commercial Real Estate (HVCRE) loans: HVCRE loans are a sub-set of commercial and land development (C&D) loans, which are reported on regulatory reports. FDIC staff estimated the amount of C&D loans classified as HVCRE by comparing Call Report and FFIEC 101 data.
- Non-Accruing and 90 day past due loans: FDIC staff used existing Call Report data on non-accruing and past due loans to assess the impact of a 150% risk weight.
- Intangibles: FDIC staff used existing Call Report data on intangible assets.
- Securitizations: FDIC staff assumed a 50% increase in the risk weight of securitization exposures based on Call Report data and discussions with bank examiners. FDIC staff assumed that the average risk weight for securitizations would increase because banks, particularly community banks, typically invest in senior tranches, whose risk-weight is less affected by the SSFA. In addition, the Standardized Approach includes the gross-up treatment which represents no change from current rules.
- Derivatives and Repo style transactions: FDIC staff estimates there will be a significant reduction in risk-weights for certain exposure under the collateral haircut approach and from the expansion of assets that would be recognized as eligible collateral under the proposal.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM MICHAEL S. GIBSON

Q.1. Is the U.S. banking system currently adequately capitalized? Please list any studies or data you relied upon to make this determination.

A.1. U.S. banking organizations of all sizes have improved their capital ratios since the financial crisis. The 19 largest banking organizations in particular have considerably more higher-quality capital than they did prior to the financial crisis. The aggregate amount of tier 1 common equity, the most loss-absorbing form of capital, held by these firms has increased by more than $300 billion since 2009, representing an increase of approximately 80 percent. [1] Implementing the Basel III proposal, along with related reforms such as regular supervisory and company-run stress tests, should help solidify these gains to better ensure the resiliency of the U.S. banking system. [2]

Before developing the Basel III proposal, the Board and the other Federal banking agencies participated in the international efforts conducted by the Basel Committee on Banking Supervision (BCBS) to study the losses experienced in past banking crises in various countries to help inform the appropriate levels of capital that banking organizations should maintain. The results of this study were made publicly available in October, 2010, and were attached as Attachment A to the letter the Federal banking agencies sent to you dated November 13, 2012. [3] As indicated in the BCBS analysis, there is no single correct approach for determining adequate capital ratio levels; rather, the analysis provides a variety of different perspectives on banking organizations' loss experiences to help inform what is ultimately a regulatory judgment regarding appropriate levels of minimum capital ratios and other measures of capital adequacy. The minimum ratio levels agreed to by the BCBS, which are the same as those in the Basel III proposal, fall within the ranges suggested by the BCBS calibration analysis. That analysis focused on information submitted by member countries regarding losses relative to risk-weighted assets incurred over long historical periods.

If the Basel III proposal were implemented today, the vast majority of top-tier bank holding companies would meet the minimum requirements outlined in the proposals. Even after considering the capital conservation buffer in addition to the minimum requirements, a substantial majority of institutions would meet the proposed capital standards. Similarly, most banking organizations with less than $10 billion in consolidated assets already hold capital that would qualify under the proposals and exceed the proposed minimum risk-based regulatory ratios.

Q.2. If the proposed Basel III rules were implemented, would your agency consider the U.S. banking system to be adequately capital-

[1] *See, http://www.federalreserve.gov/newsevents/press/bcreg/20120313a.htm.*
[2] The Basel III proposals are reflected in three notices of proposed rulemaking. *See,* 77 *Federal Register* 52888, 52909, 52958 (August 30, 2012).
[3] *See,* "Calibrating Regulatory Minimum Capital Requirements and Buffers: A Top–Down Approach" (BCBC Analysis), available at: *http://www.bis.org/publ/bcbs180.pdf.*

ized? Please explain how you made that determination and what studies and data you relied upon.

A.2. As detailed in the Federal banking agencies' letter of November 13, 2012, all banking organizations need a strong capital base to enable them to withstand periods of economic adversity yet continue to fulfill their role as a source of credit to the economy. The capital standards in the three notices of proposed rulemakings (NPRs) related to Basel III each address identified weaknesses in the current U.S. regulatory capital regime. [4]

Generally, the NPRs can be characterized as both strengthening the definition of capital so that banking organizations are better able to absorb losses and increasing the required minimum levels of capital so that banking organizations can better withstand periods of economic adversity. The NPRs also would modify risk weights to better reflect risks inherent in specific assets. Each NPR contains extensive discussion of the specific proposed changes and why the Board and other Federal banking agencies views these proposed changes as appropriate for the banking organizations that they supervise.

As described in the BCBS Analysis noted in the response to Question 1, a conceptual framework was established as the starting point for the calibration of the capital standards. Under this framework, the minimum requirement for loss-absorbing capital is defined as the amount of capital a banking organization needs to maintain so that investors, creditors, and counterparties would view it as a viable going concern. Similarly, a buffer above the minimum requirement is defined as an amount of capital sufficient for a banking organization to withstand significant downturn events while continuing to meet its minimum capital requirements. [5] As noted previously, the minimum ratio levels agreed to by the BCBS, which are the same as those proposed in the NPRs, fall within the ranges suggested by the BCBS Analysis. On this basis, the minimum capital ratios proposed in the NPRs, including the revised definition of capital, could serve as an appropriate basis for minimum capital requirements in the United States.

The Board is currently in the process of reviewing all comments on the NPRs and is carefully considering those comments as part of the rulemaking process.

Q.3. At an FDIC meeting in July, FDIC Director Thomas Hoenig stated that "as proposed, the minimum capital ratios will not significantly enhance financial stability." Bank of England Governor Mervyn King and several prominent economists have said that Basel III capital standards are insufficient to prevent another crisis. Do you disagree with these assertions? If so, why?

A.3. While there is no single measure that will prevent future crises, the proposed Basel III capital standards would address weaknesses in the current capital standards that were highlighted by the recent financial crisis. Most notably, the proposed rules would increase both the quantity and quality of capital held and require banking organizations to hold more capital for riskier exposures. These changes are expected to improve banking organization's abil-

[4] *See,* 77 *Federal Register* 52888, 52909, 52958 (August 30, 2012).
[5] *See,* BCBS Analysis, paragraph I.A.

ity to absorb losses. These improvements also would enhance banking organizations' ability to continue to function as financial intermediaries in future periods of financial and economic stress, thus improving the overall resiliency of the U.S. financial system. In this way, the NPRs are a substantial step forward toward a more stable financial system.

Q.4. Given the cost and complexity of Basel III, do you have any concerns that Basel III will further tilt the competitive landscape in favor of big banks to the detriment of small banks? Have you studied the impact of Basel III on small institutions as compared to their larger counterparts?

A.4. Many requirements in the Basel III proposal are focused on larger organizations and would not be applicable to smaller banks. These requirements include the proposed countercyclical capital buffer, the supplementary leverage ratio, enhanced disclosure requirements, and enhancements to the advanced approaches risk-based capital framework. These proposed changes, along with other recent regulatory capital enhancements such as stress testing requirements and market risk capital reforms would require large, systemically important banking organizations to hold significantly higher levels of capital relative to other organizations. The BCBS has also proposed requiring an additional capital charge for global systemically important banks (the Board has not yet proposed such a requirement).

In developing the Basel III-based capital requirements, the Board and the other Federal banking agencies conducted an impact analysis based on regulatory reporting data to estimate the change in capital that banking organizations would be required to hold to meet the proposed minimum capital requirements. Based on the agencies' analysis, the vast majority of banking organizations currently would meet the fully phased-in minimum capital requirements, and those organizations that would not meet the proposed minimum requirements would have time to adjust their capital levels by the end of the transition period. More specifically with regard to smaller banking organizations, for bank holding companies with less than $10 billion in assets that meet the current minimum regulatory capital requirements, the analysis indicated that more than 90 percent of organizations would meet the proposed 4½ percent minimum common equity tier 1 ratio today. In addition, quantitative analysis by the Macroeconomic Assessment Group (MAG), a working group of the BCBS, found that the stronger Basel III capital requirements would lower the probability of banking crises and their associated economic output losses while having only a modest negative impact on gross domestic product and lending costs, and that the potential negative impact could be mitigated by phasing in the requirements over time.

With respect to those banking organizations that would not meet the proposed requirements, including community banks with more limited capital-raising capabilities, the proposal includes lengthy transition periods. During the transition periods, banking organizations can accrete capital through the retention of earnings, as well as adjust to other elements of the proposal. The Federal banking agencies also developed a capital estimation tool to help companies, particularly community banking organizations, gain a further understanding of the possible impact of the proposals on their capital ratios. Finally, the Board sought comment on alternatives to the proposed requirements applicable to small banking organizations that could minimize their impact on those entities.

The Board is still in the process of reviewing the public comments it has received on the Basel III proposal, including those regarding the likely impact on smaller institutions. In reviewing these comments, the Board is mindful about the potential effect of the Basel III proposals on community banks. The Board will remain mindful of these comments when considering potential refinements to the proposal and will work to appropriately balance the benefits of a revised capital framework against its potential costs, including further tailoring the requirements for smaller institutions as appropriate.

Q.5. Recently, the agencies announced that they are pushing back the effective date of the proposed Basel III rules beyond January 1, 2013. This affords the agencies more time to carefully review comment letters, engage in additional outreach and collect additional data. Will the agencies use this extra time to conduct an analysis about the impact of the proposed rules on the U.S. economy and a quantitative impact study that covers all banks, regardless of size, before implementing the final rules?

A.5. As noted above, in developing the Basel III proposal, the Board used regulatory reporting data to consider the potential impact of the proposed requirements on banking organizations of all sizes. As also noted above, the Board, working with the BCBS, has already analyzed the impact of the proposed rules on U.S. economic growth and found that the net impact would likely be positive. The comment period was extended to allow interested persons more time to understand, evaluate, and prepare comments on the proposals, and the Board has to date received over 2,000 public comments on the proposals. The Board is carefully considering the commenters' views on and concerns about the effects of the NPRs on the U.S. economy and on banking organizations.

Before issuing any final rule, the Board will prepare an analysis under the Congressional Review Act (CRA). [6] As part of this analysis, the Board will assess whether the final rule is a "major rule," meaning the rule could (1) have an annual effect on the economy of $100 million or more; (2) increase significantly costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) have significant adverse effects on competition, employment, investment, productivity, or innovation. Consistent with the CRA, any such analysis will be provided to Congress and the Government Accountability Office.

In addition, as mentioned previously, the Board sought comment on significant alternatives to the proposed requirements applicable to covered small banking organizations that would minimize their impact on those entities, as well as on all other aspects of its analysis. After consideration of comments received during the public comment period and prior to adopting any final rule, the Board will

[6] 5 U.S.C. 801-808

conduct a final regulatory flexibility analysis under the Regulatory Flexibility Act.[7]

Q.6. What is the estimated impact of the Basel III rules, if finalized as proposed, on:

a. The U.S. GDP growth?

b. The probability of bank failure?

c. Availability and cost of mortgages, auto loans, student loans and small business credit?

d. The compliance costs for small, medium, and large banks?

e. The cost of insurance for consumers?

Please provide data to support your conclusions.

A.6. The recent financial crisis revealed that the amount of high-quality capital held by banking organizations in the United States was insufficient to absorb losses during periods of severe stress. The effects of having insufficient levels of capital were further magnified by the fact that certain regulatory capital instruments did not absorb losses to the extent previously expected. The lack of confidence in the banking sector drove up credit spreads on corporate bonds issued by banks, impaired banks' access to short-term funding, and depressed values of bank equities. Concerns about banking institutions arose not only because market participants expected steep losses on banking assets, but also because of substantial uncertainty surrounding estimated loss rates, and thus future earnings.[8] Further, heightened systemic risks, falling asset values, and tightening credit took a heavy toll on business and consumer confidence.[9]

The Board believes that the proposals would result in capital requirements that better reflect banking organizations' risk profiles and enhance their ability to continue functioning as financial intermediaries, including during periods of financial stress, thereby improving the overall resiliency of the banking system. The agencies participated in the development of a number of studies to assess the potential impact of the revised capital requirements, including participating in the BCBS's MAG, as well as its Quantitative Impact Study, the results of which were made publicly available by the BCBS upon their completion.[10]

This analysis has suggested that stronger capital requirements could help reduce the likelihood of banking crises while yielding positive net economic benefits. Moreover, the MAG analysis found that the requirements would only have a modest negative impact on the gross domestic product of member countries, and that any such negative impact could be significantly mitigated by phasing in the proposed requirements over time. Thus, the benefits of the Basel III proposals, as measured by the reduction of risk to the de-

[7] 5 U.S.C. 601 et seq.

[8] *See,* Chairman Bernanke's speech available at *http://www.federalreserve.gov/newsevents/speech/bernanke20100506a.htm.*

[9] *See,* Chairman Bernanke's speech available at *http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm.*

[10] *See,* "Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements" (MAG Analysis), Attachment E, available at: *http://www.bis.org/publ/othp12.pdf;* see also "Results of the Comprehensive Quantitative Impact Study", Attachment F, available at: *http://www.bis.org/publ/bcbs186.pdf.*

posit insurance fund and to the financial system, would outweigh the short-term cost of compliance with the new standards and potential impact on economic growth.

Q.7. Our housing market is currently entirely dependent on taxpayer-funded Government support through FHA and the GSEs. The Administration, however, has yet to prepare a housing finance reform plan. As a result, the future of the GSEs is still undetermined. One issue that will have to be addressed in housing finance reform is ensuring that the Basel rules are properly coordinated with the capital requirements for the GSEs in order to avoid creating any adverse incentives. Prior to the crisis, Fannie and Freddie had much lower capital requirements than did comparable banking institutions. According to one study, from 1992 through 2007 the GSE leverage ratios were between 20 and 40 (50 and 100 if MBS credit guarantees are included) whereas commercial banking sector had ratios between 10 and 15. With an implicit Government guarantee, Fannie and Freddie were able to borrow at artificially low interest rates, making it quite profitable for the GSEs to purchase mortgages and offer credit default guarantees below market rates. As a result, Fannie and Freddie grew to become institutions that threatened the financial stability of the U.S. economy. In devising the proposed Basel capital rules, did your agency consider how the rules would interact with the capital requirements of any GSE? If yes, please explain whether any changes were made to the rules to protect against adverse consequences you identified.

A.7. The proposal would maintain the banking agencies' current 20-percent risk weight for claims of or guaranteed by GSEs that are not equity exposures. The proposal would apply a 100 percent risk weight to equity securities issued by a GSE, which previously was not a uniform treatment among the agencies. As discussed in the proposal, although certain GSEs currently are in conservatorship and receive capital support from the U.S. Treasury, they remain privately owned corporations, and their obligations do not have the explicit guarantee of the full faith and credit of the United States. The agencies have long held the view that obligations of the GSEs should not be assigned the same risk weight as obligations that carry the explicit guarantee of the U.S. Government.

Our proposal would not affect the capital requirements faced by GSEs, such as Fannie Mae and Freddie Mac. Those capital requirements are not under the authority of the Federal banking agencies. In determining the risk weight for an exposure to a GSE, the Federal banking agencies have considered the potential risk associated with such exposures that would be borne by a banking organization holding the exposure. Any changes to the capital requirements for GSEs, including those that reduce any perceived advantages at the expense of private sector entities, would be determined by the FHFA and are outside the scope of this rulemaking.

Q.8. A key concern that must be addressed is ensuring that the capital requirements for Fannie and Freddie do not create incentives for banks to excessively transfer risk to the GSEs, like they did before the crisis when banks were charged a 4 percent capital requirement for holding a portfolio of mortgage loans, but only 1.6

percent if they held GSE MBS instead. Do you believe that the proposed rules appropriately address that concern, and if so, how? What analysis have you done to make that determination?

A.8. In developing the proposals, the Federal banking agencies sought to establish capital requirements and risk weights for exposures in order to ensure that banking organizations hold capital commensurate with the risk of their exposures. Thus, under the proposed framework, residential mortgages are assigned to risk-weight categories based on the relative risk of the exposures as measured by product type and underwriting criteria. Similarly, in determining the 20-percent risk weight for an exposure to a GSE, the Federal banking agencies have considered the potential risk associated with such exposures that would be borne by a banking organization holding the exposure. Further, the proposed rules would not affect the capital requirements faced by GSEs, such as Fannie Mae and Freddie Mac. Any changes to the capital requirements for GSEs, including those that reduce any perceived advantages at the expense of private sector entities, would be determined by the FHFA and are outside the scope of this rulemaking.

Q.9. Mr. Gibson, does the Federal Reserve have in-house capacity to conduct an adequate Quantitative Impact Study (QIS) for the U.S. financial institutions, including holding companies, based on their size and asset class?

A.9. The Federal Reserve has the capacity to conduct QIS exercises and previously has conducted impact analyses of banks and bank holding companies of varying sizes. For example, on an annual basis, the Federal Reserve analyzes data from the 19 large bank holding companies that have participated in the Federal Reserve's Comprehensive Capital Analysis and Review exercises, particularly with regard to those bank holding companies' ability to maintain adequate capital under stressed conditions and meet future capital requirements. These entities generally are on a transition path to meet the proposed capital requirements. Further, as described more fully below, we performed a domestic analysis of the impact of the proposals on banks and bank holding companies of varying sizes in June 2012.

Q.10. In your prepared remarks, you stated that "staff from the interagency group used both qualitative measures (such as discussions with banks) as well as quantitative measures (such as QIS data) to create the assumptions used to estimate capital as proposed." Is the QIS that you refer to a domestic study conducted by the Federal Reserve or the global study done by the Basel Committee? If it is a global study, why did the Federal Reserve rely on a global study?

A.10. The analysis I referred to in my prepared remarks is a domestic analysis that was conducted by Federal Reserve staff in June, 2012. In particular, staff considered the potential impact of the proposed requirements on banking organizations using regulatory reporting data, supplemented by certain assumptions where data needed to calculate the capital requirements was not reported. The results of the study, as well as related assumptions, and descriptions of methodologies used for the analyses were made available to the public as part of my November 14, 2012, testimony before the Committee on Banking, Housing, and Urban Affairs. These documents are available at: *http://www.federalreserve.gov/newsevents/testimony/gibson20121114a.htm.*

Q.11. The data for the global QIS done by the Basel Committee was collected as of December 31, 2009, almost 3 years ago. Would the results of that QIS differ if the same data were collected now? If so, how?

A.11. The Basel Committee publishes regular updates to the QIS as it tracks how global banks are affected by their implementation of the changes proposed by Basel III. Based on QIS data as of December 31, 2011, banks globally are in a stronger capital position than in 2009 and are closer to meeting the Basel III standards. We anticipate that future updates to the QIS using current data will show additional strengthening as banks continue their efforts to meet the fully phased-in Basel III standards.

Q.12. In response to a question on Basel that I asked Chairman Bernanke after a hearing in 2010, he stated that the Federal Reserve began conducting QIS in February 2010 and "has contributed data from the domestic QIS on a confidential basis to the global QIS." What were the results of the domestic QIS? Are you prepared to make those results publicly available? From how many banks did you collect data? How many small and community banks contributed data to that study?

A.12. Your letter specifically references the quantitative impact study (QIS) that the agencies participated in with other members of the Basel Committee on Banking Supervision (BCBS), and requests the specific U.S. findings. Although the BCBS found that, based on the QIS, the proposed changes would require surveyed banking organizations to hold more regulatory capital to meet the proposed minimum requirements, the agencies are unable to provide the specific survey information submitted by U.S. institutions as it was collected on a confidential basis, conditioned on the assurance that it would only be distributed anonymously to the BCBS for purposes of the QIS. The domestic QIS did not include data from small and community banks.

Q.13. Traditionally, insurance companies have been regulated at the State level. The proposed Basel III rules, however, will apply to thrift holding companies that own insurers. In devising the capital requirements for financial holding companies that own insurance businesses, how much did the Federal Reserve rely on State insurance capital requirements? If significantly, please explain the collaborative process that the Federal Reserve engaged in with State insurance commissioners. If not significantly, please explain why not and whether the Federal Reserve believes that capital levels for insurance enterprises as currently required by State regulators are insufficient?

A.13. Board staff met with industry representatives and the National Association of Insurance Commissioners (NAIC) on several occasions to discuss insurance-related issues, including those relating to the proposed regulatory capital framework. Board staff also consulted with the Federal Insurance Office in the context of capital requirements and stress testing.

As explained in the proposed rulemaking, the capital requirements would be consistent with section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which requires the Board to establish consolidated minimum capital requirements for depository institution holding companies (bank holding companies and savings and loan holding companies) that are no less than the generally applicable capital requirements that apply to insured depository institutions. The proposals would apply consolidated risk-based capital requirements that measure the credit risk of all assets owned by a depository institution holding company and its subsidiaries, including assets held by insurance companies. Currently, capital requirements for insurance companies are imposed by State insurance laws on a legal entity basis and there are no State-based, consolidated capital requirements that cover subsidiaries and noninsurance affiliates of insurance companies. As such, the proposed consolidated capital requirements do not rely directly on the State-based regulatory capital requirements. However, the proposal would require depository institution holding companies to consolidate and deduct the minimum regulatory capital requirement of insurance underwriting subsidiaries from total capital to reflect the capital needed to cover insurance risks. The proposed deduction treatment recognizes that capital requirements imposed by the functional regulator to cover the various risks that insurance risk-based capital captures reflect capital needs a the particular subsidiary and that this capital is therefore not generally available to absorb the losses in other parts of the organization.

The Board continues to consider the comments received on the proposed Basel III framework, including those focused on insurance activities of depository institution holding companies, as it works with the other Federal banking agencies through the rulemaking process.

Q.14. The Federal Reserve and the National Association of Insurance Commissions (NAIC) joined efforts in 2002 to study the adequacy of capital requirements for banks and insurance companies. In a joint working paper, the Federal Reserve and NAIC concluded that "the effective regulatory capital requirements for assets, liabilities, and various business risks for insurers are not the same as those for banks . . . [and] effective capital charges cannot be harmonized simply by changing the nominal capital charges on individual assets." Does the Federal Reserve still agree with the conclusion of the 2002 study? How does the Federal Reserve tailor or otherwise recognize in the proposed rules the differences in business models, funding characteristics and general risk profile between banks and insurance companies with respect to capital requirements?

A.14. In 2002, the National Association of Insurance Commissioners (NAIC) and the Federal Reserve System Joint Subgroup on Risk-Based Capital and Regulatory Arbitrage prepared a report that explored the similarities and differences between risk-based capital frameworks of the insurance sector and the banking sector. The report noted that the two frameworks differ fundamentally in the treatment and assignment of certain risks and that the effective capital charges cannot be harmonized simply by changing the nominal capital charges on individual assets.

In June 2012, the Board proposed to revise the regulatory capital requirements and to apply consolidated regulatory capital minimums to savings and loan holding companies. In developing the proposed capital rules, the Board sought to meet legal requirements and policy objectives while including flexibility for depository institution holding companies that are primarily engaged in the insurance business. As explained in the response to Question 5 above, the proposed rules are consistent with the requirements of section 171 of the Dodd-Frank Act. The proposed rules are also consistent with the Board's long-standing practice of applying consolidated capital requirements to bank holding companies, including those that include functionally regulated subsidiary insurance companies. This approach helps to eliminate regulatory capital arbitrage opportunities when a company has an incentive to book its risky exposures in legal entities in which the exposures would receive a more favorable regulatory capital treatment.

In developing the proposal, the Board also considered assets typically held by insurance companies but not depository institutions and accordingly tailored the proposed capital requirements with respect to certain insurance-related assets. The proposals would apply specific risk weights for policy loans and nonguaranteed separate accounts, which are typically held by insurance companies but not banks. These risk weights were developed after a careful review of the characteristics of these assets.

The Board has received numerous comments from the public on the proposals with respect to depository institution holding companies that have significant insurance activities and will carefully consider all of the comments raised over the course of the rulemaking.

Q.15. The Senate Banking Committee Report on the Dodd-Frank Wall Street Reform and Consumer Protection Act made it clear that the law did not mandate insurers use GAAP accounting. However, the proposed rules would require insurance enterprises to switch to GAAP. What analysis has the Federal Reserve conducted to justify such change? How will this mandated change in accounting provide more useful information about the financial health of insurance companies? How will this change impact insurance companies, both practically and financially?

A.15. As noted above, section 171 of the Dodd-Frank Act requires that the Board establish minimum consolidated risk-based and leverage capital requirements for savings and loan holding companies that are not less than the "generally applicable" risk-based and leverage capital requirements for insured depository institutions. The "generally applicable" capital requirements for insured depository institutions are calculated and reported based on U.S. generally accepted accounting principles (GAAP). This is consistent with section 37 of the Federal Deposit Insurance Act, which requires that accounting principles applicable to reports or statements that insured depository institutions file with their Federal regulators be "uniform and consistent" with GAAP. If an alternative accounting standard is required by the Federal regulator, it must be "no less stringent" than GAAP.

The proposed requirement that savings and loan holding companies calculate their capital standards on a consolidated basis using a framework that is based on GAAP standards is consistent with section 171 of the Dodd-Frank Act and would facilitate comparability across institutions. In contrast, the statutory accounting principles (SAP) framework for insurance companies is a legal entity-based framework and does not provide a consolidated basis for applying regulatory capital requirements.

In developing the proposals, the Board took into account the public comments received in response to a notice of intent (published on April 22, 2011) regarding the application of the regulatory capital requirements to savings and loan holding companies. Board staff also met with a number of industry representatives to discuss challenges associated with applying consolidated capital requirements to savings and loan holding companies, including those challenges related to GAAP.

Following the publication of the proposals, the Board received additional comments on the application of the consolidated capital requirements for savings and loan holding companies, including on cost and burden considerations for those firms that currently prepare financial statements based solely on SAP. The Board is carefully evaluating these concerns and will consider all the comments received as part of the rulemaking process.

Q.16. Under the proposals, mortgages will be assigned to two risk categories and several subcategories, but the agencies did not explain how risk weights for those subcategories are determined and why they are appropriate. How did the Federal Reserve determine the appropriate range for those subcategories? Will the Federal Reserve release the underlying research and analysis to the public?

A.16. The proposed modified mortgage treatment is designed to better differentiate and align the risks of these exposures with the appropriate category. The mortgage categories were largely informed by the historical loss-rate data of various residential mortgage products during the crisis. The proposed treatment is, therefore, designed to more accurately reflect the risk characteristics of a loan. For instance a fixed-rate, first-lien mortgage that exhibits low risk because it has a low loan-to-value ratio and has product characteristics that qualify it as a category 1 residential mortgage exposure is eligible for a preferential risk weight. Mortgages with a riskier credit profile based on product type or loan-to-value ratio would be assigned a higher risk weight.

When developing the proposed requirements, the agencies considered their various potential effects on the business activities of community banking organizations. The Board is evaluating comments from the industry that provide further clarity on potential burdens and unintended consequences of the proposed requirements and will consider the concerns raised in these comments as it works with the other Federal banking agencies through the rulemaking process.

Q.17. How does the Federal Reserve plan to integrate its capital planning requirements for the CCAR process with the Basel III proposals now that the effective date of the Basel III final rule has been delayed?

A.17. As indicated in the Board's rule regarding capital plans, the Federal Reserve requires a U.S.-domiciled, top-tier bank holding company with total consolidated assets of $50 billion (large bank holding companies) or more to submit a capital plan on an annual basis. In connection with the Board's capital plan rule (12 CFR 225.8), 19 of the largest bank holding companies are required to participate in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR). CCAR involves a detailed assessment of a bank holding company's capital plan. The capital plan must include projections of a bank holding company's pro forma capital levels over a nine-quarter forward-looking planning horizon under both expected and stressful conditions. Furthermore, in the capital plan, the bank holding company must demonstrate an ability to maintain its regulatory capital ratios and at least a 5 percent tier 1 common ratio under both expected and stressful conditions.

Currently, the capital plan rule defines regulatory capital ratios as any minimum regulatory capital ratio that the Federal Reserve may require of a large bank holding company, by regulation or order, including the bank holding company's leverage ratio and tier 1 and total risk-based capital ratios as calculated under 12 CFR part 225, Appendices A, D, E, and G, or any successor regulation. In the future, the Board may propose to modify the existing minimum regulatory capital requirements. In particular, if the Basel III proposals are finalized, the minimum regulatory ratios under the capital plan rule would include any revised risk-based capital and leverage ratio, including the common equity tier 1 ratio, which, if finalized, would replace the existing tier 1 common requirement. Finally, consistent with prior CCAR exercises, the Federal Reserve will continue to assess bank holding companies' strategies for addressing the proposed Basel III revisions to the regulatory capital framework.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM MICHAEL S. GIBSON

Q.1. A fundamental objective of Dodd-Frank was to reduce systemic risk. I am concerned that the Fed's Basel III proposal could result in bank clearing members having to hold significantly more capital when their customers use less-risky instruments. Some argue that this incentive will make it more expensive to use exchange-traded futures than bespoke swaps. Should the rule be designed to encourage the use of lower risk profile products, rather than potentially discourage it?

A.1. The Basel III proposals were designed to incentivize the use of lower risk profile products by assigning a lower risk weight to centrally cleared derivatives relative to the risk weight assigned to over-the-counter (OTC) derivatives, which are generally considered less transparent and frequently more complex. While the proposed treatment under the proposals is a departure from the zero percent risk weight assigned to exchange-traded derivatives or futures under the Board's current rules, the proposed risk weight of generally 2 percent for qualifying cleared transactions is not significantly higher than the current treatment and is substantially lower than risk weights that would be applied to OTC derivative transactions. Furthermore, the risk weighting of OTC derivatives is structured so that riskier asset classes, as well as products with longer-dated tenors, receive a higher risk weight than those asset classes that are less risky and shorter-dated.

Q.2. With the proposed use of Loan-to-Value (LTV) ratios on home mortgages in Basel III, community banks would be required to recordkeep (or keep records of) the LTVs of future and existing mortgages. Some have argued that going back through their existing portfolios and determining each individual loan's LTV at origination would be burdensome and costly. Have you considered applying this standard prospectively for smaller banks and what thoughts have gone into that?

A.2. The Federal banking agencies sought comment on the proposed treatment of residential mortgage exposures, including on the use of loan-to-value amounts in order to assign risk-based capital requirements to these exposures. In response, many commenters stated that it would be difficult for banking organizations, especially community banking organizations, to determine and track the required data on existing loan portfolios. Some commenters proposed alternatives that would reduce implementation burden, such as allowing existing mortgages to remain subject to the current risk-based capital requirements or phasing in the new requirements over time for existing portfolios. The Federal Reserve will take the commenters' concerns and alternatives into consideration as it works with the other Federal banking agencies to finalize the proposal.

Q.3. Elizabeth Duke recently said that in her discussions with community bankers, more of them report that they are reducing or eliminating their mortgage lending due to regulatory burdens than are expanding their mortgage business. In fact, she says that even if the specific issues in capital proposals can be addressed, the lending regulations might still "seriously impair" the ability of community banks to offer traditional mortgages. How or what are you going to do to ensure that the fragile housing market does not take another hit as it relates to capital requirements and Basel implementation?

A.3. In developing the proposals, the Federal banking agencies sought to better differentiate risks of mortgage exposures and ensure that banking organizations, regardless of size, hold capital commensurate with the risk of these exposures. As proposed, mortgage exposures with greater risks based on product characteristics and loan-to-value ratios would be subject to higher capital requirements.

In the proposals, the Federal banking agencies also sought to promote financial stability while avoiding undue burden on the economy as well as unintended consequences. The Federal Reserve recognizes the vital role that community banking organizations play in the U.S. mortgage market. The Federal Reserve is carefully reviewing comments from the public on the proposed risk weights for mortgages, including those from community banking organizations and will be mindful of the concerns raised in these comments as it works with the other Federal banking agencies in moving forward on the proposed capital rules.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM MICHAEL S. GIBSON

Q.1. I, and many other Members, have brought up concerns about the need to tailor rules to the size and type of entity. However, I recognize the U.S.'s leadership role on the Basel Committee, and the need to move through this period of regulatory uncertainty so that businesses can make investment decisions. How can the Committee provide regulated entities more certainty about the timeline of rules being reproposed or finalized in the future?

A.1. The Basel Committee on Banking Supervision provides a forum for regular cooperation on banking supervisory matters and promotes improvements in bank capital adequacy and risk management practices, in part, through the adoption of international standards that member countries then may implement through domestic regulation. Therefore, the Basel Committee itself is not in a position to provide certainty about the timeline regarding the U.S. domestic rulemaking process. The Federal Reserve, along with the other Federal banking agencies, is currently reviewing the thousands of comment letters received on the notices of proposed rulemaking that would revise the U.S. regulatory capital framework. The Federal Reserve is mindful of the concerns regarding uncertainty for banking organizations and is working with the other Federal banking agencies to finalize the proposals as expeditiously as possible after considering the public comments.

Q.2. I've heard concerns that the proposed rules require unrealized gains and losses on available for sale assets to be recognized within AOCI. Insurers that are Savings & Loan Holding Companies are especially apprehensive about managing increased asset-liability mismatches. Can you discuss your broader goals to encourage a long-term focus in capital management, and address these AOCI concerns?

A.2. The recent financial crisis revealed that the amount of high-quality capital held by banking organizations in the United States was insufficient to absorb losses during periods of severe stress. The effects of having insufficient levels of capital were further magnified by the fact that certain regulatory capital instruments did not absorb losses to the extent previously expected. The June 2012 proposal to amend the U.S. banking agencies' regulatory capital framework applies the lessons of the crisis, in part, by increasing the quantity and quality of capital held by banking organizations.

In addition, the proposed application of consolidated capital requirements to savings and loan holding companies is consistent with section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which requires the Board to establish consolidated minimum capital requirements for depository institution holding companies (bank holding companies and savings and loan holding companies) that are no less than the generally applicable capital requirements that apply to insured depository institutions. The proposal is also consistent with the Board's long-standing practice of applying consolidated minimum capital requirements to bank holding companies, including those that control functionally regulated subsidiary insurance companies.

The proposed treatment of AOCI, which would require unrealized gains and losses on available-for-sale securities to flow through to regulatory capital, would better reflect an institution's actual loss-absorption capacity. Commenters on the proposal have expressed concern that this treatment would introduce capital volatility, due not only to credit risk but also to interest rate risk, and would affect the composition of firms' securities holdings. In particular, depository institution holding companies with insurance activities have asserted that the proposal does not appropriately recognize the longer-term nature of their liabilities and their practice of matching asset and liability maturities. They also assert that the proposal would disproportionately affect longer term assets held by many insurance companies, thus causing them to fundamentally alter their business strategy. The Federal Reserve is evaluating these and all of the comments received and will consider them carefully as it works with the other Federal banking agencies to determine how to treat AOCI in regulatory capital.

Q.3. We've seen some recent sales of MSRs from banks to nonbanks since the proposal was released saying that MSRs may only be counted for up to 10 percent of CET1, and additional MSR holdings will be weighted at 250 percent. This is a significant change from allowing MSRs to be counted up to the equivalent of 100 percent of Tier 1 capital. The MSRs change comes in combination with more sophisticated risk-weights for mortgages that will require more capital for nonstandard and high LTV mortgages. We also have QM and QRM on the way, which will have distinct definitions from Basel rules. I am supportive of a more nuanced approach to holding capital for mortgages, but is the panel concerned that the limited overlap in these regulations could cause much greater compliance difficulty for small institutions and negatively affect access to credit among low-to-middle income borrowers?

A.3. In developing the proposed treatment for mortgage servicing assets, the Federal banking agencies considered the specific characteristics and risks of these assets and the potential safety and soundness benefits that could result from their proposed treatment. The Federal banking agencies requested comments and supporting data on the proposed treatment for MSRs. Likewise, in developing the proposed risk weights for mortgage exposures, the agencies were mindful of the proposed standards for the QM and QRM and have requested comment from the public on all aspects of the proposed changes to the regulatory capital framework. Moreover, the agencies specifically requested comment on whether mortgages that meet the QM definition (which had not yet been finalized at the time of the proposal) should be included in category 1 residential mortgage exposures.

During the comment period, the Federal Reserve and the other banking agencies also participated in various outreach efforts, such as engaging community banking organizations and trade associations, among others, to better understand industry participants' concerns about the proposals and to gather information on their potential effects, including with respect to MSRs and the proposed risk weighting of mortgages. These efforts have provided valuable additional information. The Federal Reserve will carefully consider all comments on the proposals in determining, along with the other Federal banking agencies, how to move forward with the rulemaking.

Q.4. Trade finance transactions rely on letters of credit and other off-balance sheet items, and lenders will have to set aside 100 percent capital for these items if current proposals are implemented. This transition requires 5 times more capital compared to Basel II. Do you believe that these changes are likely to affect smaller companies and emerging countries to a much greater extent? Can you respond to concerns that these proposals, as they are written, could constrict trade finance opportunities?

A.4. In 2011, the Basel Committee on Banking Supervision (BCBS) revised the Basel framework regarding trade finance transactions. [1] The BCBS revised the standardized approach to remove the sovereign floor, permitting a 20-percent risk-weighting for short-term exposure to banks in lower-income countries. The advanced approach was revised to remove the 1-year maturity floor for trade finance instruments. The U.S. banking agencies' Basel III NPR is consistent with these revisions, which would likely result in reduced capital requirements for trade finance transactions that meet certain conditions.

In addition, trade finance exposures would impact the calculation of the proposed "Basel III" supplementary leverage ratio. [2] The Basel III proposals would require companies that use the advanced approaches rules to calculate their capital requirements to maintain a minimum supplementary leverage ratio of 3 percent of total assets. This ratio's denominator calculation requires inclusion of the notional amount (effectively a 100 percent credit conversion factor) of trade finance exposures the banking organization cannot unconditionally cancel. For trade finance commitments that are unconditionally cancellable by the banking organization, they would be included in the denominator calculation at 10 percent of the notional amount.

As a general matter, the Basel Committee has indicated that it will continue to assess the supplementary leverage ratio, including through supervisory monitoring during a parallel run period in which the proposed design and calibration of the Basel III leverage ratio will be evaluated. A final decision by the Committee on the measure of exposure for certain transactions and calibration of the leverage ratio is not expected until closer to 2018. Further, the agencies have requested specific comment on the supplementary leverage ratio and are evaluating these comments, including those relating to trade finance.

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[1] *See,* BCBS, "Treatment of Trade Finance Under the Basel Capital Framework", (October 2011), available at *http://www.bis.org/publ/bcbs205.pdf.*

[2] *See, i.d.*

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WICKER FROM MICHAEL S. GIBSON

Q.1. In comment letters to Federal regulators, the Conference of State Banking Supervisors raised concerns regarding the complexity of the approach proposed by Federal banking agencies for implementing the Basel III capital accords. How has this input influenced your approach to the rulemaking process?

A.1. The Board is mindful of potential burdens that may arise from the proposed requirements. To this end, the agencies sought specific comment in the proposal regarding potential burden as well as alternatives to decrease the burden of the proposal's requirements, while still addressing safety and soundness concerns. Board staff is carefully considering all comments received on the proposal, including those provided by the Conference of State Banking Supervisors.

Q.2. In applying Basel III to community banks, did the regulators consider that most privately held community banks have fewer options for sources of capital than large banks, making it especially challenging for them to raise additional capital in the current economic climate, and that the Basel III proposal could disproportionately impact such community banks?

A.2. Before issuing the proposal, the agencies evaluated the potential impact of the proposed requirements on banking organizations by size and asset class, and determined that the vast majority of banking organizations, including community banks, already would meet the proposed minimum requirements on a fully phased-in basis and would also have capital sufficient to exceed the proposed capital buffer threshold. With respect to those banking organizations that would not meet the requirements, including community banks with more limited capital-raising capabilities, the proposal includes lengthy transition periods. During the transition period, banking organizations can accrete capital through the retention of earnings, as well as adjust to other elements of the proposal. The agencies have also developed a capital estimation tool to help companies, particularly community banking organizations, gain a further understanding of the possible impact of the proposals. The Board is carefully considering all the comments received on the proposed changes, including comments that address how to address burdens on community banks.

Q.3. Will the implementation of the proposed Standardized Approach and the mandate that mortgage loan-to-values (LTVs) be tracked require many of the Nation's smaller banks to make costly software upgrades? If so, have you considered the cost impact of such a requirement on community banks?

A.3. In developing the standardized approach proposal, the Federal banking agencies generally sought to balance increased risk sensitivity with the potential regulatory and compliance burden on banking organizations. The Board is sensitive to concerns expressed by commenters that the requirement to track loan-to-value ratio information as part of the framework to assign risk weights to mortgage exposures would represent additional burden for banking organizations, especially smaller banking organizations that may need to upgrade their data systems. As it works to finalize the proposal with the other agencies, the Board will be taking into account these comments as well as proposed alternatives to reduce the burden of implementation on banking organizations under the proposed framework.

Q.4. Did the regulators consider the effect on the economy and consumers if community banks reduce mortgage lending significantly due to Basel III?

A.4. The agencies have considered the costs and benefits of the various proposed treatments of the Basel proposals, specifically seeking to balance the need to promote financial stability while minimizing the impact on economic growth and credit availability. The agencies also included several specific questions in the proposal regarding the mortgage treatment. The Board is sensitive to concerns that higher risk weights and increased compliance cost may lead to more expensive mortgages and reduce access to credit and will carefully consider community bankers' as well as all other comments on the proposal as it works with the other Federal banking agencies on the rulemaking.

Q.5. Please explain whether or not the proposed higher capital requirements for past due loans are a form of "double accounting," given that banks already are supposed to reserve for these losses.

A.5. The proposed 150 percent risk weight for past-due loans reflects the increased risk of loss associated with an exposure that is 90 days or more past due or on nonaccrual status. By contrast, the allowance for loan and lease losses (ALLL) addresses losses that have been incurred, which is defined under U.S. GAAP as probable of occurring (based on historical loss statistics). Thus, the 150 percent risk weight for past-due loans complements rather than duplicates the ALLL.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SHELBY FROM JOHN C. LYONS

Q.1. Is the U.S. banking system currently adequately capitalized? Please list any studies or data you relied upon to make this determination.

A.1. Generally speaking, national banks and Federal thrifts of all sizes are better capitalized today than they were prior to the crisis. The Call Report data below show national bank and Federal thrift capital ratios before the crisis and the ratios in the middle of 2012.

Bank Size As Of 2012Q2	Count Of Banks	Tier 1 Leverage Ratio 2006Q4	Tier 1 Leverage Ratio 2012Q2	Tier 1 Leverage Ratio % Change	Tier 1 Risk-Based Capital Ratio 2006Q4	Tier 1 Risk-Based Capital Ratio 2012Q2	Tier 1 Risk-Based Capital Ratio % Change	Total Risk-Based Capital Ratio 2006Q4	Total Risk-Based Capital Ratio 2012Q2	Total Risk-Based Capital Ratio % Change
greater than $250B	6	6.4%	8.1%	27.6%	8.4%	11.5%	37.6%	11.6%	14.1%	21.0%
$100B - 250B	6	10.6%	9.7%	-8.9%	11.3%	13.1%	15.9%	14.4%	15.5%	7.8%
$10 - 100B	48	7.9%	10.3%	30.3%	9.2%	14.5%	57.4%	12.1%	16.5%	36.3%
$1 - 10B	180	8.8%	10.8%	23.3%	11.6%	17.1%	47.4%	13.1%	18.3%	39.9%
$250m to $1B	527	10.5%	11.1%	5.3%	14.3%	17.4%	21.4%	15.4%	18.6%	20.6%
less than $250m	1,120	12.1%	12.1%	0.0%	18.0%	20.4%	13.4%	19.1%	21.6%	13.0%
Grand Total	1,887	7.1%	8.9%	24.5%	9.1%	12.6%	38.8%	12.1%	15.0%	23.1%

Q.2. If the proposed Basel III rules were implemented, would your agency consider the U.S. banking system to be adequately capitalized? Please explain how you made that determination and what studies and data you relied upon.

A.2. While capital positions have improved based on current capital metrics, the proposed changes to our capital standards should help to cement these improved capital positions and ensure that banks are in a better position to deal with future financial market turbulence. In addition, the proposed changes are intended to provide a better metric by which to measure each bank's capital position as they should enhance the risk sensitivity of the existing capital framework.

Q.3. At an FDIC meeting in July, FDIC Director Thomas Hoenig stated that "as proposed, the minimum capital ratios will not significantly enhance financial stability." Bank of England Governor Mervyn King and several prominent economists have said that Basel III capital standards are insufficient to prevent another crisis. Do you disagree with these assertions? If so, why?

A.3. We believe that the proposed enhancements to our capital standards will help to strengthen the banking system's resiliency and will enhance financial stability through higher levels and quality of capital and through improved risk sensitivity. Banking crises have occurred for as long as there have been banks, and we do not, therefore, believe that the proposed standards would necessarily succeed in preventing another crisis. However, we expect that banks would be better positioned to navigate any future crisis under the proposed rules than under the current rules.

Q.4. Given the cost and complexity of Basel III, do you have any concerns that Basel III will further tilt the competitive landscape in favor of big banks to the detriment of small banks? Have you studied the impact of Basel III on small institutions as compared to their larger counterparts?

A.4. We do not anticipate that small banks will be disadvantaged under the proposed rules relative to large banks for a number of reasons. First, large banks will be subject to essentially two capital regimes under section 171 of the Dodd-Frank Act. Under this provision, the largest banks are required to not only comply with the capital standards that have been developed specifically for large, internationally active banks, but they are also required to comply with the standards that are "generally applicable", i.e., those that are applied to smaller institutions. In addition, there are several aspects of the proposals that would apply only to the largest banks. For example, smaller banks can ignore the advanced approaches NPR in its entirety, which contains changes from Basel III that only apply to the largest U.S. banks. In addition, the countercyclical buffer, which is meant to make banks hold more capital during periods of excessive credit growth, is a Basel III provision that would apply only to the largest banks. Similarly, enhanced disclosures would apply only to banks with total consolidated assets of $50 billion or more. While not included as part of this set of proposals, the largest banks will also have to hold an additional cushion of capital under the Global Systemically Important Bank (G–SIB) surcharge, which could be up to 3.5 percent of additional common equity.

To measure the potential impact of the proposals, the OCC conducted burden and cost estimates for all OCC-supervised banks consistent with the Unfunded Mandates Reform Act and for OCC-supervised small banks pursuant to the Regulatory Flexibility Act. Our analysis showed that the majority of banks, including community banks, will meet the new higher capital requirements without raising additional capital. For those banks that might need to raise additional capital, the proposals include a number of transition provisions to ease the burden. However, for a substantial number of the smallest banks (i.e., those with assets of $175 million or less), our initial analysis determined that the compliance costs likely could be significant. These costs include additional recordkeeping and systems costs associated with implementing the alternatives to credit ratings.

The Comptroller has stated publicly that he is aware of the concerns of community bankers and is very interested in looking at ways to reduce the potential burden on small banks without compromising the OCC's goal of raising the quantity and quality of capital and setting minimum standards that require more capital for more risk. To help facilitate community bank comments, the Federal banking agencies provided an estimator tool so that community bankers could give us more specific empirical data on the potential impact of the proposals. The agencies will consider any such empirical analysis that community banks provide.

For any final rule, the OCC will complete final assessments under both the Unfunded Mandates Reform Act and the Regulatory Flexibility Act. Also, for any final rule, the OCC will determine whether the rule is a "major rule" for purposes of the Congressional Review Act (e.g., whether it will have an annual effect on the economy of $100 million or more).

Q.5. Recently, the agencies announced that they are pushing back the effective date of the proposed Basel III rules beyond January 1, 2013. This affords the agencies more time to carefully review comment letters, engage in additional outreach and collect additional data. Will the agencies use this extra time to conduct an analysis about the impact of the proposed rules on the U.S. economy and a quantitative impact study that covers all banks, regardless of size, before implementing the final rules?

A.5. The OCC is required to complete a final assessment of the rule under the Regulatory Flexibility Act, and we plan to complete an assessment under the Unfunded Mandates Reform Act. We will take into account any comments received on the costs and benefits of the NPRs in fulfilling these statutory mandates. Additionally, at the final rule stage, the OCC will prepare an analysis under the Congressional Review Act. As part of this analysis we will assess whether the final rule is a "major rule," meaning the rule could (1) effect the economy by $100 million or more; (2) increase significantly costs or prices for consumers, individual industries, Federal, State, or local government agencies, or geographic regions; or (3) have significant adverse effects on competition, employment, investment, productivity, or innovation. The analysis will be provided to the Congress and the Government Accountability Office (GAO).

Q.6. What is the estimated impact of the Basel III rules, if finalized as proposed, on:

a. The U.S. GDP growth?

b. The probability of bank failure?

c. Availability and cost of mortgages, auto loans, student loans and small business credit?

d. The compliance costs for small, medium, and large banks?

e. The cost of insurance for consumers?

Please provide data to support your conclusions.

A.6. If finalized as proposed, we estimate that the overall cost of the proposed capital rules would be approximately $145.1 million. This estimate reflects one-time systems costs of approximately $46.5 million and ongoing capital costs of $98.6 million per year once banks fully implement the new rule. The overall estimate reflects the cost of capital some banks would need to raise to meet the new minimum capital standards, compliance costs associated with establishing the infrastructure to determine correct risk weights using the new alternative measures of creditworthiness, and compliance costs associated with new disclosure requirements.

The vast majority of banks in the United States already hold capital that would satisfy even the highest new capital standard set to take effect on January 1, 2019. Table 1 shows our estimates of the cumulative number of OCC-regulated banking organizations that would fall short of the new minimum capital standards if the banks took no action and held their capital at December 31, 2011, levels. We estimate that those 195 institutions would have to raise approximately $84 billion in new capital, which is approximately nine percent of the amount of capital currently held by OCC-regulated banking organizations. Because most banks in the United States already meet the new Basel III capital standards and those institutions that do need to raise capital have 6 years in which to do it, we estimate that the proposed rule will not affect U.S. GDP growth. Most of the dampening effect on GDP growth that can occur when banks reduce lending to increase capital would have occurred in the past when banks increased their capital levels in response to the financial crisis.

While higher capital levels reduce the probability of bank failure, [1] we did not estimate how Basel III rules will affect these probabilities. The probability of bank failure will vary from bank to bank and will depend on capital and a variety of other factors, best summarized in regulatory CAMELS ratings. These CAMELS factors include capital adequacy, asset quality, management quality, earnings, liquidity, and sensitivity to market risk.

Because the proposed rules would change the risk weights for residential mortgages, we do expect the increased risk sensitivity could have some effect on the cost and availability of residential mortgages. Indeed, one of the objectives of the proposed rule is to use variations in risk weights to differentiate between high-risk and low-risk mortgages, securitizations, and sovereign debt. In particular, for residential mortgages with a lower risk weight under the proposed rule, namely category one mortgages with loan-to-value ratios less than or equal to 60 percent, costs may decrease and availability may increase. For residential mortgages with higher risk weights under the proposed rules, for example, mortgages with loan-to-value ratios greater than 90 percent, we expect that costs may increase and availability decrease. There are, however, a large number of factors beyond risk weights that affect the cost and availability of mortgages and other loans. The interaction of these factors along with possible changes in bank behavior towards risk makes it difficult to arrive at an accurate estimate of the proposed rules' impact on mortgage cost and availability. The risk weights for auto loans, student loans, and small business loans do not change under the proposed rules.

Table 2 shows our estimates of compliance costs associated with determining new risk weights under the proposed rule. As shown in Table 2, we estimate compliance costs of approximately $36,000 per institution for small- and medium-sized banks. For large banks, we estimate compliance costs of approximately $111,000 per institution. We did not attempt to estimate the cost of insurance for consumers.

[1] *See,* for instance, Arturo Estrella, Sangkyun Park, and Stavros Perlstlanl, "Capital Ratios as Predictors of Bank Failure", *Economic Policy Review*, Federal Reserve Bank of New York, July 2000, pp. 33–52.

Table 1. Cumulative Number of OCC-Regulated Banking Organizations Short of the Transition Schedule for Minimum Capital Requirements and Estimated Risk-weighted Assets, December 31, 2011.

Institutions not meeting:	Dec. 31, 2011	Jan. 1, 2013	Jan. 1, 2014	Jan. 1, 2015	Jan. 1, 2016	Jan. 1, 2017	Jan. 1, 2018	Jan. 1, 2019
New minimum capital requirements	56	56	56	56	89	89	135	195

Table 2. Estimated Costs of Creditworthiness Measurement Activities, December 31, 2011

Institution	Number of institutions	Estimated hours per institution	Estimated cost per institution	Estimated cost
Small banking organizations (assets < $10 bil.)	1,177	425	$36,125	$42,519,125
Large banking organizations (assets ≥ $10 bil.)	36	1,300	$110,500	$3,978,000
Total	1,213			$46,497,125

Q.7. Our housing market is currently entirely dependent on taxpayer-funded Government support through FHA and the GSEs. The Administration, however, has yet to prepare a housing finance reform plan. As a result, the future of the GSEs is still undetermined. One issue that will have to be addressed in housing finance reform is ensuring that the Basel rules are properly coordinated with the capital requirements for the GSEs in order to avoid creating any adverse incentives. Prior to the crisis, Fannie and Freddie had much lower capital requirements than did comparable banking institutions. According to one study, from 1992 through 2007 the GSE leverage ratios were between 20 and 40 (50 and 100 if MBS credit guarantees are included) whereas commercial banking sector had ratios between 10 and 15. With an implicit Government guarantee, Fannie and Freddie were able to borrow at artificially low interest rates, making it quite profitable for the GSEs to purchase mortgages and offer credit default guarantees below market rates. As a result, Fannie and Freddie grew to become institutions that threatened the financial stability of the U.S. economy. In devising the proposed Basel capital rules, did your agency consider how the rules would interact with the capital requirements of any GSE? If yes, please explain whether any changes were made to the rules to protect against adverse consequences you identified.

A.7. In developing our proposed capital standards, we focused on the institutions that we regulate, although we did consider the potential impact of the proposals on the broader economy. We did not explicitly consider the regulatory capital requirements for Fannie Mae and Freddie Mac as set forth by their regulator, the Federal Housing Finance Agency.

Q.8. A key concern that must be addressed is ensuring that the capital requirements for Fannie and Freddie do not create incentives for banks to excessively transfer risk to the GSEs, like they did before the crisis when banks were charged a 4 percent capital requirement for holding a portfolio of mortgage loans, but only 1.6 percent if they held GSE MBS instead. Do you believe that the proposed rules appropriately address that concern, and if so, how? What analysis have you done to make that determination?

A.8. While the proposed rules attempt to provide for a more risk sensitive approach to mortgage loans held by banks, the proposed treatment for exposures to Fannie Mae and Freddie Mac are carried over from the existing rules. This was partly due to the explicit Government support that has been provided to these institutions. If and when the two housing entities are restructured, we will consider the risks that exposures to the firms present to banks and will revise the capital treatment for such exposures accordingly. However, given the uncertainty as to what the ultimate structure and risks of these entities might look like, we believed it was premature to make significant changes to the capital standards at this time.

Q.9. Mr. Lyons, how do the proposed rules address the diverse landscape of our financial system, including mid-size banks, community banks, regional banks, and other market participants? Please provide specific examples. What analysis did OCC conduct to determine that the Basel III model should be applied to those market participants? How did OCC determine that the proposed capital regime is adequate for institutions based on their size or asset class?

A.9. As I noted in my testimony, in developing the U.S. capital proposals we did not adopt a "one-size fits all approach." Rather, we carefully evaluated each element of the Basel III framework and assessed to which banks it should be applied. In making these assessments, the Federal banking agencies strove to calibrate the requirements to reflect the nature and complexity of the financial institutions involved. As a result, and consistent with the higher standards for larger banks required by section 165 of the Dodd-Frank Act, many of the provisions in the proposed rules are only for larger banks and those that engage in complex or risky activities: community banks with more basic balance sheets are largely or completely exempted. For example, smaller banks can ignore the advanced approaches NPR in its entirety, which contains changes from Basel III that only apply to the largest U.S. banks. In addition, the countercyclical buffer, which is meant to make banks hold more capital during periods of excessive credit growth, is a Basel III provision that would apply only to the largest banks. Similarly, enhanced disclosures would apply only to banks with total consolidated assets of $50 billion or more. While not included as part of this set of proposals, the largest banks will also have to hold an additional cushion of capital under the Global Systemically Important Bank (G–SIB) surcharge, which could be up to 3.5 percent of additional common equity.

There are areas, however, where we believe a more uniform regulatory capital approach across banks is warranted. For example, the proposals include a consistent definition of what counts as regulatory capital for banks of all sizes. A consistent definition helps to limit the complexity of having multiple definitions for banks of varying size and also helps to reduce opportunities for regulatory capital arbitrage.

The regulatory capital standards set forth in the proposals are meant to be minimum requirements that are appropriate for banks of various sizes and with varying business models. These standards do not obviate the need for more tailored analysis of each bank's capital adequacy, which is part of our overall supervisory process.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR MENENDEZ FROM JOHN C. LYONS

Q.1. A fundamental objective of Dodd-Frank was to reduce systemic risk. I am concerned that the Fed's Basel III proposal could result in bank clearing members having to hold significantly more capital when their customers use less-risky instruments. Some argue that this incentive will make it more expensive to use exchange-traded futures than bespoke swaps. Should the rule be designed to encourage the use of lower risk profile products, rather than potentially discourage it?

A.1. While the use of central counterparties improves the safety and soundness of both cleared OTC and exchange-traded products through the multilateral netting of exposures and market transparency, the increased use of central counterparties also has the potential for increased systemic risk as counterparty credit risk is concentrated in these entities. The proposed rules introduce a capital requirement for banks' exposure to this risk. The proposed capital requirement takes into account the margin provided to the central counterparty by its members as well as the capital of the central counterparty itself. We are still reviewing the comments received on this issue to determine the ultimate resolution of this topic.

Q.2. With the proposed use of Loan-to-Value (LTV) ratios on home mortgages in Basel III, community banks would be required to recordkeep (or keep records of) the LTVs of future and existing mortgages. Some have argued that going back through their existing portfolios and determining each individual loan's LTV at origination would be burdensome and costly. Have you considered applying this standard prospectively for smaller banks and what thoughts have gone into that?

A.2. These changes are part of the Standardized Approach proposal. As proposed, they would be applicable to all mortgages with no grandfathering provisions; however this treatment would not come into effect until 2015. This proposed delayed implementation was intended to provide sufficient time for banks to adapt to the new standards. Several commenters have suggested that we apply the proposed mortgage treatment on a prospective basis, and that is something that we will carefully consider as we move forward.

Q.3. Elizabeth Duke recently said that in her discussions with community bankers, more of them report that they are reducing or eliminating their mortgage lending due to regulatory burdens than are expanding their mortgage business. In fact, she says that even if the specific issues in capital proposals can be addressed, the lending regulations might still "seriously impair" the ability of community banks to offer traditional mortgages. How or what are you going to do to ensure that the fragile housing market does not take another hit as it relates to capital requirements and Basel implementation?

A.3. Our goal with the proposed modifications to our regulatory capital framework is to create a more robust and stronger banking system that is better positioned to withstand financial market stresses. Ultimately, this would help to ensure that access to financing can flow more efficiently to all sectors of the economy, including housing. In addition, the proposed rules included long transition provisions to allow banks to more easily adjust to the higher capital standards. Nevertheless, we recognize the concerns that commenters have raised with our proposals, particularly as they relate to the housing market, the multitude of regulatory reforms that are underway in this sector of the economy, and the burden the proposals may pose to community banks. We are committed to carefully considering all of these comments in deciding how to best move forward.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WARNER FROM JOHN C. LYONS

Q.1. I, and many other Members, have brought up concerns about the need to tailor rules to the size and type of entity. However, I recognize the U.S.'s leadership role on the Basel Committee, and the need to move through this period of regulatory uncertainty so that businesses can make investment decisions. How can the Committee provide regulated entities more certainty about the timeline of rules being reproposed or finalized in the future?

A.1. While we are dedicated to the Basel process of developing and promulgating globally consistent standards for the largest internationally active banks, our ultimate goal is to ensure the safety and soundness of the U.S. banking system. Fortunately, standards advanced by the Basel Committee are generally consistent with our domestic priorities and objectives, and if they are not, we will make adjustments as necessary.

While we are constantly seeking to improve both the international and domestic processes for proposing and finalizing standards and regulations, there are limits to our ability to provide certainty during the rulemaking process. We continue to strive to provide as much information as possible, both at the domestic rulemaking stage and on an international level as part of the Basel Committee, to ensure that our proposals can be understood and assessed by industry participants so that meaningful comment can be provided. Nevertheless, certainty in terms of the structure of rules and when those rules might be finalized is difficult given that we are open to revising our proposals based on the feedback that we receive. The Basel Committee and the Federal banking agencies attempted to mitigate some of this uncertainty by providing for long transition periods over which banks could adjust and adapt to any new regulations.

As I noted in my testimony, in developing the U.S. capital proposals we did attempt to tailor our proposals. We carefully evaluated each element of the Basel III framework and assessed to which banks it should be applied. In making these assessments, the Federal banking agencies strove to calibrate the requirements to reflect the nature and complexity of the financial institutions involved. As a result, and consistent with the higher standards for larger banks required by section 165 of the Dodd-Frank Act, many of the provisions in the proposed rules would affect only larger banks and those that engage in complex or risky activities; community banks with more basic balance sheets are largely or completely exempted from such provisions.

Q.2. I've heard concerns that the proposed rules require unrealized gains and losses on available for sale assets to be recognized within AOCI. Insurers that are Savings & Loan Holding Companies are especially apprehensive about managing increased asset-liability mismatches. Can you discuss your broader goals to encourage a long-term focus in capital management, and address these AOCI concerns?

A.2. The OCC is committed to ensuring banks maintain adequate capital, and, as I noted in my testimony, regulatory capital standards are but one component in a larger and more comprehensive process of bank supervision. For example, we recently issued guidance for national banks and federally chartered thrifts (the Federal Reserve Board regulates Savings and Loan holding companies) that focuses on the need for these institutions to assess their capital adequacy.[1] Part of this process, as well as part of our examination process of assessing the strength of a bank's capital position, involves evaluating a bank's unrealized gains and losses.

The rationale for the proposed AOCI treatment is that ignoring unrealized losses has the potential to mask the true financial position of a bank. This is particularly true when a bank is under stress and when creditors are most likely to be concerned about unrealized losses that could inhibit a bank's ability to meet its obligations. Nonetheless, this is an issue that numerous commenters flagged as a concern and is one that we are carefully reviewing. Because our review and rulemaking process have not been completed, it would be difficult to comment on the ultimate resolution of this topic without prejudging the process.

Q.3. We've seen some recent sales of MSRs from banks to nonbanks since the proposal was released saying that MSRs may only be counted for up to 10 percent of CET1, and additional MSR holdings will be weighted at 250 percent. This is a significant change from allowing MSRs to be counted up to the equivalent of

[1] *See,* OCC Bulletin 2012-16, "Guidance for Evaluating Capital Planning and Adequacy".

100 percent of Tier 1 capital. The MSRs change comes in combination with more sophisticated risk-weights for mortgages that will require more capital for nonstandard and high LTV mortgages. We also have QM and QRM on the way, which will have distinct definitions from Basel rules. I am supportive of a more nuanced approach to holding capital for mortgages, but is the panel concerned that the limited overlap in these regulations could cause much greater compliance difficulty for small institutions and negatively affect access to credit among low-to-middle income borrowers?

A.3. We recognize the concerns about regulatory burden, including concerns about overlap with other regulatory initiatives related to residential mortgages, and we take these concerns very seriously. Our intention is not to negatively affect credit access to low-to-middle income borrowers, and we will carefully consider the comments we have received in deciding on the best way forward.

Q.4. Trade finance transactions rely on letters of credit and other off-balance sheet items, and lenders will have to set aside 100 percent capital for these items if current proposals are implemented. This transition requires 5 times more capital compared to Basel II. Do you believe that these changes are likely to affect smaller companies and emerging countries to a much greater extent? Can you respond to concerns that these proposals, as they are written, could constrict trade finance opportunities?

A.4. One of the main effects of the proposed rules on trade finance relates to the treatment of off-balance sheet trade-related transactions such as letters of credit under the supplementary leverage ratio. The supplementary leverage ratio is proposed to apply only to the largest, internationally active banking organizations, some of which are active in the trade finance arena. Commenters have raised concerns with this treatment as well as some concerns with other technical aspects of the proposals as they relate to trade finance. We will review these comments carefully to assess whether any changes to the proposals are warranted.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR WICKER FROM JOHN C. LYONS

Q.1. In comment letters to Federal regulators, the Conference of State Banking Supervisors raised concerns regarding the complexity of the approach proposed by Federal banking agencies for implementing the Basel III capital accords. How has this input influenced your approach to the rulemaking process?

A.1. We are carefully reviewing all of the comments we received on the proposals, including those submitted by the Conference of State Bank Supervisors. Given that the rulemaking process has not been completed and that we are still reviewing comments, it would be difficult to speak to how particular comments have shaped our views at this time.

Q.2. In applying Basel III to community banks, did the regulators consider that most privately held community banks have fewer options for sources of capital than large banks, making it especially challenging for them to raise additional capital in the current economic climate, and that the Basel III proposal could disproportionately impact such community banks?

A.2. Yes. The proposed transition period, which in some cases extends to 2022, was intended to allow banks time to adjust to the heightened capital standards. Nevertheless, concerns related to the ability of community banks to access capital markets has been raised by many commenters, and we will weigh these issues as we decide how to move forward.

Q.3. Will the implementation of the proposed Standardized Approach and the mandate that mortgage loan-to-values (LTVs) be tracked require many of the Nation's smaller banks to make costly software upgrades? If so, have you considered the cost impact of such a requirement on community banks?

A.3. For a substantial number of the smallest banks (i.e., those with total assets of $175 million or less), our initial analysis determined that the compliance costs could be significant. These costs include additional recordkeeping and systems costs associated with implementing the alternatives to credit ratings. The Comptroller has stated publicly that he is aware of the concerns of community bankers and is very interested in looking at ways to reduce the potential burden on small banks without compromising the OCC's goal of raising the quantity and quality of capital and setting minimum standards that require more capital for more risk. The Federal banking agencies requested comment on their costs and burden estimates and on ways to reduce cost and burden without sacrificing safety and soundness. As I noted in my testimony, the Federal banking agencies received a substantial number of comments, and as we move forward with any final rules, we will consider the comments and empirical analysis that community banks provided in their comments.

Q.4. Did the regulators consider the effect on the economy and consumers if community banks reduce mortgage lending significantly due to Basel III?

A.4. Because the proposed rules will change the risk weights for residential mortgages, we do expect that increased risk sensitivity could have some effect on the cost and availability of residential mortgages. Indeed, one objective of the proposed rule is to use variations in risk weights to differentiate between high-risk and low-risk mortgages, securitizations, and sovereign debt. In particular, for residential mortgages with a lower risk weight under the proposed rule, namely category one mortgages with loan-to-value ratios less than or equal to 60 percent, costs may decrease and availability may increase. For residential mortgages with higher risk weights under the proposed rule, for example, mortgages with loan-to-value ratios greater than 90 percent, we expect that costs may increase and availability decrease. There are, however, a large number of factors beyond risk weights that affect the cost and availability of mortgages and other loans. The interaction of these factors along with possible changes in bank behavior towards risk makes it difficult to arrive at an accurate estimate of the proposed rules' impact on mortgage cost and availability.

Q.5. Please explain whether or not the proposed higher capital requirements for past due loans are a form of "double accounting," given that banks already are supposed to reserve for these losses.

A.5. The capital requirements for past due loans is not a form of double counting or "double accounting." Allowance for loan losses (reserves) under accounting standards and regulatory capital serve fundamentally different roles. Under existing U.S. GAAP, accounting reserves represent the estimated amount needed to recognize losses that have been incurred as of the balance sheet date. In contrast, the role of regulatory capital is to protect a bank from unexpected (and thus unreserved) losses. For example, if a loss has been incurred on a past due loan, an accounting reserve should be established in a sufficient amount to recognize the estimated loss. There is no automatic requirement that an accounting allowance be established for all past due loans. Nevertheless, the ultimate loss on that past due loan is not known with certainty, and it is this uncertainty that the capital charge is meant to cover. It is also worth noting that the existing capital rules require capital for past due loans, even though these loans generally already have accounting reserves established. The difference between the existing and proposed treatment, therefore, is more a matter of the amount of capital that must be set aside, rather than whether capital should be set aside or not.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT SUBMITTED BY JOHN VON SEGGERN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, COUNCIL OF FEDERAL HOME LOAN BANKS

The Council of Federal Home Loan Banks (Council), appreciates this opportunity to submit a written statement for the Committee's consideration in connection with the hearing entitled "Oversight of Basel III: Impact of Proposed Capital Rules". The Council is a trade association whose members are the 12 Federal Home Loan Banks (FHLBanks),[1] and the proposed rules will have a significant impact on FHLBank member institutions as well as the mortgage markets as a whole. The Council is therefore very interested in the Basel III rulemaking proposals and the congressional oversight of their development.

The Council agrees that the capital rules need to be revisited, and that a strong capital buffer is an important safeguard for both individual institutions and our financial system as a whole. Accordingly, the Council supports the underlying goals of the Basel III accord to strengthen the capital base of depository institutions and their holding companies; to provide a buffer against systemic risk; and to better correlate the required amount of capital and the risks presented by particular assets and financial activities. However, for the reasons described below, we are unable to support the rules as proposed. We have attached to this statement a copy of the comment letter we submitted to the regulatory agencies concerning these proposed rules.

I. Risk Weight for Mortgages Held in Portfolio

We are concerned that the proposed capital treatment of mortgage loans held in portfolio by community-based institutions is excessive. Under the proposal there would be a significant increase in the minimum capital requirements for both first and second mortgages, up to twice the current requirements, unless the loan-to-value ratio of the mortgage loan is 80 percent or less. As a result, unless a home buyer can put down at least 20 percent of the cost of the home, plus closing costs, the cost of mortgage credit will increase as the mandated capital increases. This will harm both the consumer and the overall economy.

Today, and for the foreseeable future, mortgage underwriting standards are very stringent. Under recent statutory reforms, the Federal banking agencies and the Consumer Financial Protection Bureau (CFPB) have many new tools that will significantly raise the credit standards utilized in the extension of mortgage credit by regulated financial institutions without the need for across the board higher capital requirements. Mortgages being made today, and that will be made under these new rules, will look much more like the traditional mortgages that were originated prior to 2005. These mortgages have proven to be safe with very low default and foreclosure rates. Burdening these loans with excessive capital requirements will unnecessarily impede the availability of mortgage credit, increase costs to consumers, and hurt our economic recovery. Especially hard hit will be first-time home buyers, who often require high loan-to-value (LTV) lending.

LTV ratio is an important factor in loan performance. A significant cash investment in a home purchase clearly lowers the risk of default and the loss given a default. However, further analysis needs to be undertaken regarding the impact of lower downpayments when other factors indicate that the borrower is creditworthy. When other factors indicate that the borrower is a prime credit, the fact that the downpayment is less than 20 percent should not automatically push the loan into a higher capital category.

II. Effect of Other Laws and Regulations and Market Conditions

Another concern in the proposal is that it fails to recognize the impact of all of the statutory and regulatory changes that have been adopted or that are expected to be adopted shortly. The CFPB is currently promulgating regulations to implement the requirement of the Dodd-Frank Act that prohibits a creditor from making a mortgage loan without considering the ability of the borrower to repay. These regulations will effectively require that lenders use very conservative mortgage underwriting standards, or face potential liability for failure to consider adequately repayment ability when originating the loan. The Dodd-Frank Act also requires regu-

[1] Created by Congress in 1932, the FHLBanks are 12 regional banks, cooperatively owned and used to finance housing and economic development. More than 7,700 lenders nationwide are members of the FHLBank System, representing approximately 80 percent of America's insured lending institutions. The FHLBanks and their members have been the largest and most reliable source of funding for community lending for nearly eight decades.

lators to implement new rules relating to the securitization of mortgage loans. These regulations will define a "qualified residential mortgage" which will likely become the standard for all new mortgages that are going to be placed into securitization vehicles. These regulations will also require stringent loan underwriting. The CFPB is given broad powers to regulate mortgage originators, including restrictions on incentive compensation. All of these new mandates will significantly raise the credit standards utilized in the extension of mortgage credit by regulated financial institutions. In establishing new capital rules, it is critically important to consider these new laws and regulations, both in terms of the quality of mortgages that will be originated going forward, and also in the cumulative impact these new rules will have on mortgage availability and cost. We are concerned that the cumulative effect of the proposed capital requirements coupled with the other new statutory and regulatory requirements could result in an adverse impact on mortgage availability and affordability.

III. Balloon Payments

Under the proposal, loans that have balloon payment features are subject to more onerous capital requirements. Many of our member institutions, including community financial institution members, view balloon loans as an effective way to provide low cost mortgages to their customers. Many customers desire these loans because they know in advance that they will be moving within a prescribed number of years, or for other legitimate reasons. For community-based lenders, the use of these products has not been problematic. We also note that from an asset-liability management perspective, community banks are more readily able to retain balloon mortgages on their balance sheet, reducing the need for securitization. Retention of the mortgages on balance sheet also provides a strong incentive for community banks to effectively and prudently underwrite and manage the risks in these loans.

Congress specifically recognized the importance of these loans in rural and agricultural communities and created an exception in the Dodd-Frank Act's qualified mortgage standard for balloon loans made by lenders in these communities. We urge that any final capital rule treat well underwritten balloon loans like any other first mortgages, especially if such loans are written by lenders in rural or agricultural areas.

IV. Home Equity Lines of Credit and Second Liens

During the past decade, some borrowers avoided making any meaningful downpayment towards the purchase of the home by using a second loan. These so-called "piggy back" loans increased the risk to the lender. However, home equity lines of credit (HELOC) and second liens that are not used for the purpose of funding downpayments are an important source of financing for home improvement projects, medical expenses, educational payments, and paying off more expensive credit card debt. Under the proposal, junior liens are subject to more stringent capital requirements, which can double the capital required under current rules.

V. Commercial Real Estate

The proposal would increase the risk weight of certain commercial real estate loans from 100 percent to 150 percent. The increased risk weight would apply to so-called High Volatility Commercial Real Estate (HVCRE) exposures: loans for the acquisition, development and construction of multifamily residential properties and commercial buildings. The higher risk weight would not apply to loans made for the development and construction of 1-4 family residential units.

Commercial real estate lending is very important to our community bank members to support their local communities. We understand that this can be a volatile asset, and that during the financial crisis these loans deteriorated, but not across the board for every community bank. Recent indications are that this market is recovering, underwriting standards have improved, and there is a significant need for credit in this sector. The regulators have numerous tools to prevent a deterioration in underwriting standards, and the use of these tools would be a more effective means of addressing the potential risks in this type of asset than raising the capital charge for these loans without regard to the quality of the loan. Further, it makes little sense to have a higher capital charge for a secured loan (150 percent) than the capital charge that would result from making an unsecured loan to the same builder.

VI. Mortgage Servicing Rights

Another area of our concern is the treatment of mortgage servicing rights (MSRs). These are valuable assets that produce a stream of income that can contribute to the health of our financial institutions. Under current rules the value of these assets is marked to market quarterly, and the market value is then haircut by 10 percent.

We understand that MSRs are sensitive to changes in interest rates, prepayment rates and foreclosure rates. However, they are nevertheless a valuable asset that can be sold in a liquid market. Under the proposal these assets would essentially be driven out of the banking system, to the detriment of both consumers and insured institutions and their holding companies. We believe that the proposed treatment needs to be reevaluated to ensure that it will not result in harming our institutions rather than protecting them.

We recommend that the agencies' concerns with regard to MSRs focus on the quality of the loans associated with the servicing rights, and not lump all MSRs together. If the underlying loans are prudently underwritten the associated MSRs should be allowed to count as an asset for up to 100 percent of Tier 1 capital. If the underlying loan does not meet this standard, a more stringent limit on the associated MSRs may be appropriate.

VII. Securitization Issues

The proposal does not change the treatment of MBS that are issued or backed by a U.S. agency (zero-percent risk weight), or MBS that are issued or backed by Fannie Mae or Freddie Mac (20-percent risk weight). However, the proposal makes significant changes in the treatment of private label MBS, that will make it much more difficult for community banks to purchase private label MBS, and increase the capital charge for those that do. This result will unnecessarily impede the return of private capital to the mortgage markets.

VIII. Inclusion of AOCI in Calculation of Tier 1 Capital

The "minimum regulatory capital ratios, capital adequacy" proposal would require that unrealized gains and losses on securities held as "available for sale" (AFS) be reflected in a banking organization's capital account. The inclusion of these unrealized gains and losses creates the potential for several unintended consequences.

Community banks holding interest rate sensitive securities for asset-liability management or other sound business reasons, would see changes to their capital ratios based solely on interest rate movements rather than changes from credit quality, without commensurate change in capital ratios resulting from movements in the market price for other assets classes or long term or structured liabilities.

Community banks would be incented to hold short term or floating rate securities to minimize the impact on their capital ratios from changes in interest rates. Although there could be beneficial reasons for holding longer term fixed rate assets such as municipal or mortgage securities, banks could be hesitant to do so realizing the long term, fixed rate nature of these investments would subject them to increased price sensitivity and impact on their Tier 1 capital.

Community banks would be incented to hold their securities in "held to maturity" category rather than available for sale to avoid the impact on their capital ratios. This would adversely affect a bank's ability to manage its balance sheet to respond to growing loan demand or changing economic fundamentals.

The inclusion of unrealized gains and losses in AFS securities would diminish the relevance and transparency of the Tier 1 capital measure due to institutions receiving inflated levels of Tier 1 capital from declining interest rates (and hence) rising market values of fixed rate, noncallable securities. This change in capital could overstate the amount of Tier 1 capital if the subject bank had no intention of monetizing the gain on the securities; this could be the case in a scenario where economic activity is stagnant resulting in falling interest rates.

IX. Disparate Competitive Impacts

As discussed above, we believe that the proposal will impose capital charges that are far in excess of the actual risks presented, especially for mortgages written since the financial crisis of 2008. As a result, nonregulated lenders will be able to gain market share at the expense of regulated banking institutions. Making this problem more severe, the bifurcated capital approach (standardized vs. advanced) creates the potential for significant disparate competitive impacts across the two approaches. The significant differences in capital requirements across the advanced and standardized approaches will almost certainly negatively impact community financial institutions as they compete with larger institutions in low credit risk portfolios like traditional mortgages.

X. Conclusion

The Council supports the efforts of the Federal regulators to enhance regulatory capital requirements for insured depository institutions and their holding companies. However, overall we are unable to support these rules as proposed. We believe that any increased risk weight must be appropriately aligned with the actual risk presented by the asset. High capital for nontraditional or poorly underwritten loans makes sense, and we support that policy. However, applying higher capital charges for traditional and prudently underwritten mortgages would be extremely counter-productive to our economy and to the American consumer.

Thank you for the opportunity to include our views in the hearing record. If you have any questions, please contact me at the Council's Washington office.

COUNCIL OF FEDERAL
HOME LOAN BANKS

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October 22, 2012

Mr. Robert deV. Frierson
Secretary, Board of Governors of the Federal Reserve System
20th St. and Constitution Avenue, N.W.
Washington, D.C. 20551
RE: Docket NoR-1430; RIN No. 7100 AD 87 and Docket NoR-1442; RIN No. 7100 AD 87

Mr. Robert E. Feldman
Executive Secretary
Attention; Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RE: RIN 3064-AD 96 and RIN 3064-AD 95

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 1-5
Washington, D.C. 20219
RE: Docket ID OCC-2012-0009 and Docket ID OCC-2012-0008

Re: Standardized Approach for Risk Weighted Assets; Market Discipline and Disclosure Requirements

Re: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Dear Sir or Madam:

I am submitting this comment letter on behalf of the Council of Federal Home Loan Banks (Council). The Council appreciates the opportunity to comment on two notices of proposed remaking ("NPR" or "Proposals") that are designed to implement the Basel III capital framework and make other changes to U.S. capital rules. The first NPR, denominated "Standardized Approach," is the focus of the majority of our comments. We will indicate in the body of the letter the comments that are directed at the accompanying notice (Minimum Regulatory Capital Ratios, Capital Adequacy).

The Council appreciates the need to revisit the capital rules applicable to U.S. depository institutions and holding companies. As the financial crisis made clear, a strong capital buffer is a necessary safeguard for both individual institutions and our financial system as a whole. The Council agrees with the underlying goals of Basel III to strengthen the capital base of depository institutions and their holding companies; provide a buffer against systemic risk; and better correlate the required amount of capital and the risks presented by particular assets and financial activities. The concept of adjusting regulatory capital requirements to risk has been a key goal of our regulatory capital system since the implementation of the original Basel Accord in 1989. One of the most important reforms made by the Basel III revision is to require the use of more sensitive measures of risk when establishing minimum capital levels for the internationally active banking organizations that are subject to the so-called "advanced approach."

We are concerned, however, that the regulatory proposals, and in particular the provisions relating to the treatment of mortgage loans held by community-based institutions, fail to accurately align required capital and the credit risks presented by mortgage loans made since the financial crisis. We have a number of other concerns with the proposals, including the proposed treatment of private label mortgage-backed securities, other issues relating to securitization, mortgage servicing rights, commercial real estate lending, and the inclusion of Accumulated Other Comprehensive Income (AOCI) in the calculation of Tier 1 capital. All of these issues and others will be addressed in more detail below.

I. <u>Mortgages Held In Portfolio Will Be Subject to Significantly Higher Capital Charges</u>

Under current risk-based capital rules, a prudently underwritten mortgage loan, with a loan-to-value (LTV) of 90 percent or less, is assigned a risk weight of 50 percent. The current rules also consider private mortgage insurance as a substitute for part of the cash down payment. As a result, a borrower can combine a small down payment with private mortgage insurance in order to meet the 90 percent LTV standard. Likewise, by statute, both Fannie Mae and Freddie Mac consider the existence of private mortgage insurance as an alternative to meeting those companies' LTV requirements.[1]

Pursuant to the NPR, mortgages are divided into two categories, and then subdivided based on the LTV of the mortgage. Unlike the current rules, private mortgage insurance does not count when determining LTV. Therefore, a home buyer with a 10 percent cash down payment who obtains mortgage insurance on the loan will be considered as having a 90 percent LTV for regulatory capital purposes, notwithstanding the mortgage insurance protection.

Category 1 mortgages have lower capital charges than Category 2 loans. In order to be a Category 1 loan, the mortgage must be a first mortgage, may not exceed 30 years, and cannot have a balloon payment or negative amortization feature. The borrower's income must be verified. If it is an adjustable rate mortgage, any increase in the interest rate cannot exceed two percent per year, or six percent over the life of the loan. Most importantly, the creditor must make a reasonable determination that the borrower can repay the loan based on the maximum interest rate possible during the first five years of the obligation. These requirements are very

[1] Section 305(a) (2) of the Federal Home Loan Corporation Charter Act and Section 302(b) (2) (C) of the Federal National Mortgage Association Charter Act.

similar to the recently proposed definition of a "Qualified Mortgage," (QM) under section 1412 of the Dodd-Frank Act.[2] All other mortgage loans are Category 2 loans.

The risk-weight is then determined by looking at the LTV. For Category 1 loans, the following risk-weights apply:

LTV	Risk Weight
Equal to or less than 60%	35%
Greater than 60% but equal to or less than 80%	50%
Greater than 80% but equal to or less than 90%	75%
Greater than 90%	100%

For Category 2 loans the following risk weights apply:

LTV	Risk-Weight
Equal to or less than 80%	100%
Greater than 80% by equal to or less than 90%	150%
Over 90%	200%

II. Category 1 Mortgages Are Safe and Sound Loans

Historically, mortgage lending has been a safe and sound activity presenting very low credit risk to banking institutions. Until the recent period of high defaults and foreclosures following the initiation of the financial crisis, default rates on residential mortgages were exceedingly low. According to Federal Reserve Board data, from 1991 through 2005 the charge off rate on mortgage loans held by all commercial banks was never higher than .45 percent, and typically was much lower.[3] Delinquency rates on loans held by commercial banks during this period were likewise low, generally between two and three percent.[4] However, beginning in the early 2000s, lenders (primarily unregulated mortgage companies) began originating vast numbers of so-called Alt-A and subprime loans, often with one or more non-traditional terms such as: *no* down payment requirement; principal balances in excess of the market value of the home; low- or no-documentation requirement; very low initial rate for two or three years followed by a large jump in the applicable interest rate; deferred payments or interest-only payments, or negative amortization.[5] Ultimately, these loans began to default in record numbers.[6]

There is no question that the LTV ratio is an important factor in loan performance. A significant cash investment in a home purchase clearly lowers the risk of default and the loss given a default. However, the available evidence indicates that the proposed risk weights for

[2] The major differences between the two requirements are that with the Qualified Mortgage points and fees are limited to three percent, and the mortgage underwriting must comply with any debt to income or residual income guidance that may later be issued by the prudential regulators. 76 Fed. Reg. 27390 (May 11, 2011).
[3] http://www.federalreserve.gov/releases/chargeoff/chgallnsa.htm
[4] Id.
[5] Board of Governors of the Federal Reserve System, *The Federal Reserve and the Financial Crisis* at 8-12 (2012).
[6] Although (as noted below) recent studies have shown that loans that used these nontraditional terms and non-traditional underwriting standards have experienced increased default rates, it should also be noted that investors have filed complaints asserting that mortgage companies and other lenders originating these non-traditional loans did not adhere to stated underwriting standards.

Category 1 mortgages with an LTV in excess of 80 percent are not warranted. Category 1 mortgages are, by definition, similar to the traditional mortgages that were fully documented and underwritten according to historical standards. And because regulated financial institutions will have to determine independently that the borrower has a reasonable "ability to repay" the loan, according to its terms, when the loan is made, it is likely that Category 1 mortgages will be subject to even more stringent underwriting than loans made before the subprime boom. In this regard it is important to note that the requirement to make this independent "ability to repay" determination is not presumed to have been met if the loan also meets the requirements for a qualified mortgage (QM). Thus a lender would have to make an "ability to repay" determination for all Category 1 loans, including qualified mortgages.[7]

In light of the characteristics of Category 1 mortgages it can be expected that these loans will have, at worst, the same performance characteristics of loans made in the early 2000s. Low down payment loans (loans with an LTV in excess of 80 percent) made up a substantial percentage of loans made before the subprime boom. For example, in the years 2001 - 2004, approximately 40 percent of the single-family loans purchased by the GSEs had LTVs in excess of 80 percent.[8] For first-time home buyers the percent of high LTV lending is greater. Low down payment mortgages constituted the *majority* of the financing for first-time home buyers in every year since 1990.[9]

Historically, these loans (including loans with LTVs in excess of 80 percent) performed well.[10] The delinquency rates for single- family mortgages purchased by the GSEs were less than 1 percent for every year between 1988 and 2005.[11] As noted earlier, the delinquency rates on residential mortgages held in portfolio by U.S. banks were also exceedingly low in the years prior to 2005. Based on the performance of mortgage loans at the time, the Basel Committee recommended a risk weight of 35 for residential mortgages under the Basel II standardized approach issued in 2004.[12] The Basel Committee has not amended this recommendation as part of the Basel III revisions. In 2011, the Center for Responsible Lending conducted a review of mortgage loan performance and concluded "badly structured loans and lack of underwriting, *not low down payments*, caused the foreclosure crisis."[13] A logistical regression analysis performed in 2011 by Genworth Financial Corporation using CoreLogic data for 2000-2008 found that the loan terms with the greatest correlation with performance were related to loan amortization (whether a loan is an interest- only loan or a negative amortization loan), and that the amount of the down payment (evaluated in 1% increments) was only the sixth most significant variable. Although we have not conducted our own analysis of this data, these studies conclude that

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[7] We question whether this represents good policy. A better approach would be to consider all QM loans as Category 1 and also subject to the presumption that the ability to repay test has been satisfied.

[8] Department of Housing and Urban Development, *Profiles of GSE Mortgage Purchases: 2001-04* at Table 10. Attached as Exhibit A.

[9] J. Duca, J.Muellbauer and A. Murphy, Federal Reserve Bank of Dallas, *Shifting Credit Standards and the Boom and Bust in U.S. House Prices: Time Series Evidence from the Past Three Decades* 31 (2012).

[10] According to economist Mark Zandi, "While there is no question that larger down payments correlate with better loan performance, low down payment mortgages that are well underwritten have historically experienced manageable default rates, even under significant economic or market stress." Mark Zandi, *Special Report: The Skinny on Skin in the Game*, Moody's Analytics (March 11, 2011).

[11] Office of Federal Housing Enterprise Oversight, *Annual Report to Congress,* Table 9 and 19 (June 15, 2006).

[12] Basel Committee on Bank Supervision, International Convergence on Capital Methods and Capital Standards (Basel II) (Rev. June 2006).

[13] Center for Responsible Lending, Comment Letter submitted to the federal banking agencies on Interagency Proposed Rule on Credit Risk Retention (August 1, 2011).

various non-traditional loan terms and weak underwriting have a stronger correlation with loan defaults than the amount of the down payment.

Category 1 mortgages are safe and sound loans that should have similar, if not better performance characteristics as the mortgages that were made before the subprime boom. These loans included millions of high LTV mortgages that performed well. Any change in the current capital rules should be based on the performance of well underwritten traditional mortgages, and should exclude mortgages that have non-traditional structures or followed nontraditional underwriting standards, such as without documentation of the borrower's resources. We believe that the performance data for high LTV pre-2002 loans demonstrate that the proposed risk weights for mortgages with LTV ratios in excess of 80 percent are too high. We urge the regulators to revisit the proposal in order to ensure that the regulatory capital charge is aligned with the economic risk of Category 1 loans that have LTV ratios in excess of 80 percent.

III. Effect of Other Laws and Regulations and Market Conditions

Another shortcoming in the proposed capital regulation is that it fails to recognize fully the impact of all of the statutory and regulatory changes that have been adopted or that are expected to be adopted shortly. The Dodd-Frank Act prohibits a creditor from making a mortgage loan without considering the ability of the borrower to repay.[14] And the Consumer Financial Protection Bureau (CFPB) is currently promulgating regulations to implement this requirement. These regulations will effectively require that lenders use very conservative mortgage underwriting standards,[15] or face potential liability for failure to consider adequately repayment ability when originating the loan. The Dodd-Frank Act also requires regulators to implement new rules relating to the securitization of mortgage loans.[16] These regulations will define a "qualified residential mortgage" which will likely become the standard for all new mortgages that are going to be placed into securitization vehicles.[17] These regulations will also require stringent loan underwriting. The CFPB is given broad powers to regulate mortgage originators, including restrictions on incentive compensation.[18] All of these new mandates will significantly raise the credit standards utilized in the extension of mortgage credit by regulated financial institutions. In establishing new capital rules, it is critically important to consider these new laws and regulations, both in terms of the quality of mortgages that will be originated going forward, and also in the cumulative impact these new rules will have on mortgage availability and cost. We are concerned that the cumulative effect of the proposed capital requirements coupled with the other new statutory and regulatory requirements could result in an adverse impact to mortgage availability and affordability.

Even without these new laws and regulations, the evidence from the market is quite clear. Unlike the experience of the last decade, in which qualifying for a mortgage loan was easy, it is currently very difficult to qualify for a mortgage loan. Banks and other lenders are demanding far higher credit quality than they did even before the early 2000s.[19] The problem for our

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[14] See Title XIV, Subtitle B of the Dodd-Frank Act.
[15] 76 Fed. Reg. 27390 (May 11, 2011).
[16] Section 941 of the Dodd-Frank Act.
[17] 76 Fed. Reg. 24090 (April 29, 2011).
[18] Semi-annual Report of the CFPB, *Significant Rules, Orders and Initiatives*, (July 2012).
[19] Joint Center for Housing Studies Harvard University, *The State of the Nation's Housing* 2012 at 19.

economy is not unsafe mortgage lending but the reluctance of private capital to enter the market. Higher capital requirements will only further reduce the availability of mortgage credit.

Concerns that mortgage underwriting standards may decline in the future are also misplaced. If there were ever an attempt to return to the home loan financing practices of the mid-2000s, the regulators have a broad array of new tools at their disposal to stop these practices.[20] In addition, the Financial Stability Oversight Council (FSOC) has the authority to determine that any financial practice presents risks to the U.S. financial system, and can request that the appropriate federal agency implement steps to prevent or curtail that activity.[21] This authority is not limited to large institutions, and thus the FSOC can use its influence to curtail risky practices conducted by any financial company without regard to asset size.

Regulatory tools, including the ability to raise underwriting standards immediately through regulatory guidance, should mitigate the concerns that the experience of the past decade will be repeated. Utilization of these regulatory tools to address risky lending practices is more effective than raising capital standards on all mortgage loans that have an LTV in excess of 80 percent, which would raise the cost of mortgage loans for all but the wealthiest segments of our country, and limit the ability of credit-worthy, first-time home buyers and minorities to obtain mortgage loans.[22]

IV. Balloon Payments

Another issue raised by the proposal is the blanket prohibition on balloon payment loans in Category 1. The Council believes there are balloon payment loans that are appropriate to a borrower's needs and repayment abilities and should be considered for Category 1 treatment with a risk weighting that addresses associated risk. Many of our member institutions, including community financial institution members, view balloon loans as an effective way to provide low cost mortgages to their customers. Many customers desire these loans because they know in advance that they will be moving within a prescribed number of years, or for other legitimate reasons. For financial institutions that have applied appropriate underwriting standards, particularly community- based lenders, the use of these products has not been problematic. We also note that from an asset-liability management perspective, community banks are more readily able to retain balloon mortgages on their balance sheet, reducing the need for securitization. Retention of the mortgages on balance sheet also provides a strong incentive for community banks to effectively and prudently underwrite and manage the risks in these loans.

Congress specifically recognized the importance of these loans in rural and agricultural communities and created an exception in the Dodd-Frank Act's qualified mortgage standard for

[20] The federal banking agencies are empowered to issue enforceable real estate lending standards under section 304 of the Federal Deposit Insurance Corporation Improvement Act. The agencies are also authorized to increase required capital levels on an institution specific basis when they find that increased capital is required in light of the activities and assets of that institution. 12 U.S.C. § 3907(a) (2). See, e.g.. 12 C.F.R. § 3.9 ("The OCC is authorized ... to establish such minimum capital requirements for a bank as the OCC, in its sole discretion, deems appropriate in light of the particular circumstances of that bank."

[21] Section 120 of the Dodd-Frank Act.

[22] Increasing the capital charge, and thus the cost, for mortgage loans with an LTV in excess of 80 percent will hurt all first-time home buyers that predominately rely on lower down payment mortgages. However, minorities as a group will be hardest hit. According to data from the American Housing Survey, 72 percent of African-American buyers and 63 percent of Hispanic buyers took out mortgages that were above 90 percent LTV in 2009.

balloon loans made by lenders in these communities.[23] We urge that any final capital rule treat well underwritten balloon loans as for Category 1 mortgages, especially if such loans are written by lenders in rural or agricultural areas.

V. Home Equity Lines of Credit and Second Liens

During the past decade, some borrowers avoided making any meaningful down payment towards the purchase of the home by using a second loan. These so-called "piggy back" loans increased the risk to the lender. However, home equity lines of credit (HELOC) and second liens that are not used for the purpose of funding down payments are an important source of financing for home improvement projects, medical expenses, educational payments, and paying off more expensive credit card debt. Under the proposal, all junior liens are considered Category 2 loans, unless the same party holds both the first and second exposure.[24]

The interest rate on home equity lines is typically indexed, but not capped. In addition, home equity lines of credit often allow the homeowner the option to make interest- only payments for an established period of time. Under the proposal the existence of either of these features would result in classifying a home equity line as a Category 2 loan. Thus, even if the HELOC is in a first lien position, or is held by the same lender who holds the first loan, the home equity line would be a Category 2 exposure.

As Category 2 loans, both HELOCs and second mortgages would have twice the capital charge as would be imposed on a first lien with a similar LTV. Even worse, if the second lien or HELOC does not qualify for Category 1 treatment, for example because it has a balloon feature or because its interest rate is not capped, and both loans are held by the same bank, the entire exposure (both the first loan and the second or HELOC) is treated as a Category 2 mortgage asset.

The proposal fails to distinguish between traditional variable rate loans and the much more troublesome teaser loans with an artificially low teaser rate for two or three years followed by a high jump in the interest rate resulting in "payment shock" to the borrower. Traditional variable rate loans, such as an underwritten 5/1 or 7/1 product, have been demonstrated to be both safe for the lender and useful to the consumer. Clearly there are many other well underwritten variable rate loans that should not be lumped into Category 2 because of the poor performance of the non-traditional 2/28 and 2/27 teaser products. Moreover, from an interest rate risk perspective, 5/1 or 7/1 mortgages, as examples, are likely to be more readily and effectively hedged by a financial institution than might be the case with a 30-year mortgage.

In short, the risk weight of home equity lines and other second mortgages that are made in conformance with traditional and prudent underwriting standards (including consideration of the combined first and second liens for LTV exposure purposes, and a determination that the borrower has the ability to repay both loans) should be adjusted to reflect the actual risk of the second loan or home equity line of credit. Simply doubling the risk weight from current rules does not appear to reflect the actual increase in risk.

VI. Commercial Real Estate

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[23] Section 1412 of the Dodd-Frank Act.

[24] Category 1 treatment is allowed if the same lender holds both the first lien and the second lien or HELOC, with no intervening liens. The lender combines the two exposures to determine the LTV of the combined loan. If both exposures meet the requirements for Category 1, the combined loan will qualify for Category 1 treatment. But if either loan does not meet the standards for Category 1, both loans are treated as Category 2 exposures.

The proposal would increase the risk weight of certain commercial real estate loans from 100 percent to 150 percent. The increased risk weight would apply to so-called High Volatility Commercial Real Estate (HVCRE) exposures: loans for the acquisition, development and construction of multi-family residential properties and commercial buildings. The higher risk weight would *not* apply to loans made for the development and construction of 1-4 family residential units.

Commercial real estate lending is a significant source of income for many of our community bank members. We understand that this can be a volatile asset, and that during the financial crisis many of these loans went bad. However, recent indications are that this market is recovering, underwriting standards have improved, and there is a significant need for credit in this sector. The regulators have numerous tools to prevent deterioration in underwriting standards, and the use of these tools would be a more effective means of addressing the potential risks in this type of asset than raising the capital charge for these loans without regard to the quality of the loan. Further, it makes little sense to have a higher capital charge for a secured loan (150 percent) than the capital charge that would result from making an unsecured loan to the same builder.

VII. Mortgage Servicing Rights

The term "mortgage servicing rights" (MSRs) refers to the right to service a mortgage by collecting monthly payments, managing the escrow, paying taxes and other fees, and dealing with delinquent loans and loans in foreclosure. These rights arise when a mortgage loan is sold but the servicing is retained by the loan originator or sold to a third party. For example, a community bank may want to sell a loan into a securitization pool, but retain the right to service the loan in its local community. Also, a small bank may wish to originate loans but sell the servicing to a larger institution that has the appropriate infrastructure to service the loan efficiently.

Under current rules, mortgage servicing rights may be treated as an asset of a bank in amounts up to 100 percent of the bank's Tier 1 capital. The value of the bank's MSRs must be reduced to 90 percent of fair market, and adjusted quarterly. The "minimum regulatory capital ratios, capital adequacy" proposal would reduce the amount of MSRs that may be included as a bank asset to 10 percent of the bank's common equity Tier 1 capital, and the remainder would have to be deducted from capital. Under the "standardized approach" NPR, the MSRs that are not deducted would have to be risk weighted at 250 percent. In essence, under the proposed treatment many banking organizations would likely leave this market, and the mortgage servicing function would move to nonbanking entities.

While mortgage servicing rights are sensitive to changes in interest rates, prepayment rates and foreclosure rates, they are nevertheless a valuable asset that has performed well prior to the financial crisis. These assets can be sold in a liquid market and can be used to support a bank's other activities. [25] Driving this asset out of the banking system will greatly decrease the

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[25] See, e.g. Testimony of FDIC Chair Sheila Bair, Hearing on Implementing the Dodd-Frank Act, Before the Senate Comm. On Banking, Housing and Urban Affairs, 111th Cong. 2d Sess. 67 (2010)(While the value of mortgage servicing rights can be volatile, they clearly have value); Testimony of Federal Reserve Board Tarullo, Hearing Before the Subcommittee on Security and International Trade of the Senate Comm. on Banking, Housing and Urban

number of companies able and willing to perform this activity, and thereby raise the cost of servicing for the public, and deprive regulated financial companies of a stream of revenue that can be used to support other lending activities. The net effect will be to increase the cost of mortgage loans.

Because MSRs gain value when interest rates increase, this asset acts as a natural hedge against interest rate risk. If MSRs are forced out of the banking system, banks will either have more exposure to the risks of increased interest rates, or will have to purchase swaps and other hedges at an increased cost to the institution, and ultimately to the public.

We are well aware that in recent times MSRs suffered significant declines in value due to the large number of delinquencies, defaults and foreclosures. All of these events raise the cost of servicing. In addition, when a loan is refinanced the servicing fee for that loan is terminated. However, the capital rules should be forward looking, and not based on the unique circumstances of the past few years. As previously noted, on a going forward basis home mortgages will be underwritten, and will likely perform, according to historical norms. In the 1990s, the regulatory agencies increased the amount of MSRs that could be counted as an asset from 50 percent to 100 percent of Tier 1 capital.[26] At that time the agencies expressed the view that the requirement to haircut this asset by 10 percent, and determine its fair market value on a quarterly basis, would provide sufficient safety to enable banks to hold MSRs in an amount of up to 100 percent of Tier 1 capital.

We recommend that the agencies' concerns with regard to MSRs focus on the quality of the loans associated with the servicing rights, and not lump all MSRs together. If the underlying loans are prudently underwritten (*i.e.*, if they meet the QM standards that will soon be released), the associated MSRs should be allowed to count as an asset for up to 100 percent of Tier 1 capital. If the underlying loan does not meet this standard, a more stringent limit on the associated MSRs may be appropriate.

VIII. Securitization Issues

Under the capital rules in effect today, mortgage-backed securities (MBS) that are issued or backed by an agency of the United States, such as GNMA, are given a zero-risk weight. MBS issued by a Government-Sponsored Enterprise, such as Fannie Mae or Freddie Mac are assigned a 20 percent risk weight. Private label MBS are assigned a risk-weight based on the credit rating of the position. For example, securities in the highest or next highest grade (AAA or AA) have a risk weight of 20 percent. Securities in the third highest grade (A) have a risk weight of 50 percent.

The proposal does not change the treatment of MBS that are issued or backed by a U.S. agency (zero-percent risk weight), or MBS that are issued or backed by Fannie Mae or Freddie Mac. However, the proposal makes significant changes in the treatment of private label MBS.

For private label securities the proposal does away with reliance on credit ratings,[27] and instead will require the investing bank to undertake its own due diligence of the credit risks

Affairs, 111th Cong. 2d Sess. 16 (July 20, 2011)(Mortgage servicing rights, again, are not the same as an asset already on the balance sheet, but they are an expected stream of earning which have performed well in the past)

[26] 63 Fed. Reg. 42669 (Aug. 10, 1998).

[27] Under section 939A of the Dodd-Frank Act the regulatory agencies are required to end the use of credit ratings for regulatory purposes.

involved, and demonstrate to the bank's examiner a comprehensive understanding of the structure and risks of the security. The due diligence must include an analysis of the features of the securitization that could materially affect performance, including the cash flow waterfall, triggers, credit enhancements, and the specific definitions of default used in the securitization.

A bank would also be required to consider relevant information about the performance of the underlying securities, market data, price volatility, trading volume, liquidity support, percentage of loans that are 30, 60 and 90 days past due, loans in foreclosure, overall default rates, occupancy data, average LTV of the underlying loans, average credit scores of the borrowers, the extent of the geographic diversification of the loans and size, depth and concentration of the market for the securitization including bid-ask spreads. The bank's analysis must be conducted and documented prior to the purchase of the instrument. If the bank cannot demonstrate such a comprehensive understanding, it would be required to risk weight the exposure at 1,250 percent.

Based on the bank's analysis, the appropriate risk weight for the security would be determined using one of two prescribed models in the regulation.

With respect to banks selling mortgages into a securitization pool, the "minimum regulatory capital ratios, capital adequacy" NPR requires the selling bank to deduct from Tier 1 regulatory capital any non-cash gain on sale that would be recognized under generally accepted accounting principles, and apply a risk weight of 1,250 percent to any credit enhancing interest only securities generated by the securitization.

We agree with the proposal that the risk weight for mortgage backed securities issued or guaranteed by a U.S. agency and Government-Sponsored Entities should not be changed. However, we are concerned that the proposal inhibits private label securitization by making it very difficult, if not impossible, for community and smaller banks to purchase private label MBS. These institutions simply do not have the capacity to undertake the extensive analysis demanded by the proposal, and thus are likely to be frozen out of the market for these securities. The result will prevent these banks from acquiring higher yielding securities that will be backed by the stringently underwritten mortgages that are now being made.

We understand that under the Dodd-Frank Act the banking agencies can no longer link the risk weight for securities with the credit rating of those instruments. However, expecting small and community banks to engage in a sophisticated analysis of the products is not realistic and will have broader negative consequences for the housing markets. We therefore recommend that for small and community banks the requirement to engage in the extensive due diligence be waived and that a risk weight of 20 percent be assigned to private label MBS provided that all of the loans meet certain underwriting standards. In particular, we suggest that once the QM test is finalized, establishing the regulatory standard for a low risk mortgage, securities backed solely by such mortgages should be assigned a risk weight of 20 percent.

Further, we believe that the purchasing bank should be able to rely on a representation by the securitizer that all the loans qualify, and that the obligation of the purchasing bank be limited to a sampling of the loans. A small or community bank should be able to rely on an independent third party to conduct this sample. Finally, we recommend that the requirement in the "minimum regulatory capital ratios, capital adequacy" NPR that a bank selling loans into a securitization deduct from Tier 1 capital all non-cash gains on sale should be revisited. Rather than a dollar for dollar deduction, the agencies should consider a supervisory approach in which the value of this asset could be adjusted if the examiner has reason to believe it is not valid.

IX. Repurchase Agreements

Under current rules, capital is required for any on-balance sheet exposure that arises from a repo-style transaction (that is, a repurchase agreement, reverse repurchase agreement, securities lending transaction, and securities borrowing transaction). For example, capital is required against the cash receivable that a banking organization generates when it borrows a security and posts cash collateral to obtain the security. The proposal would impose a capital charge on all repo-like transactions, regardless of whether the transaction generates an on-balance sheet exposure.

Under the NPR, a banking organization would be required to apply a 100 percent conversion factor to off-balance sheet repurchase agreements, securities lending or borrowing transactions, and other similar exposures. The off-balance sheet component of a repurchase agreement would equal the sum of the current market values of all positions the banking organization has sold subject to repurchase.

Repurchase agreements are a key part of the financial management of the Federal Home Loan Bank (FHLBank) system. The proposed rule will increase the capital charge for banks that sell securities to a FHLBank with the obligation to repurchase these securities at a later date. When the FHLBank is a counterparty, there is essentially no risk to the selling bank that the FHLBank will not be able to comply with its obligation to return the securities to the counterparty. We would urge the regulators to provide an exemption from this new capital requirement for off-balance sheet positions held as part of a repo transaction.

X. Swaps

FHLBanks, as well as other financial institutions holding interest rate sensitive assets, engage in derivative transactions to protect against changes in prevailing interest rates. The proposed rule requires banking organizations to hold capital with respect to such derivative agreements, with the amount of the capital charge dependent upon the counterparty, the collateral, and the remaining maturity on the contract. The proposal would not require a capital charge for derivatives cleared through a central clearinghouse. The FHLBanks use a wide variety of swap agreements to hedge the various types of funding that our member banks require, and therefore the use of a clearinghouse is not practicable for all swaps transactions. Further, when the FHLBank is a counterparty, there is essentially no credit risk to the counterparty. We believe that capital should not be charged when the counterparty is a FHLBank, even if a clearinghouse is not used.

XI. Inclusion of AOCI in Calculation of Tier 1 Capital

The "minimum regulatory capital ratios, capital adequacy" NPR would require that unrealized gains and losses on securities held as "available for sale" (AFS) would be reflected in a banking organization's capital account. The inclusion of these unrealized gains and losses creates the potential for several unintended consequences.

Community banks holding interest rate sensitive securities for asset-liability management or other sound business reasons, would see changes to their capital ratios based solely on interest rate movements rather than changes from credit quality, without commensurate change in capital ratios resulting from movements in the market price for other assets classes or long term or structured liabilities.

Community banks would be incented to hold short term or floating rate securities to minimize the impact on their capital ratios from changes in interest rates. Although there could be beneficial reasons for holding longer term fixed rate assets such as municipal or mortgage securities, banks could be hesitant to do so realizing the long term, fixed rate nature of these investments would subject them to increased price sensitivity and impact on their Tier 1 capital.

Community banks would be incented to hold their securities in "held to maturity" category rather than available for sale to avoid the impact on their capital ratios. This would adversely affect a bank's ability to manage its balance sheet to respond to growing loan demand or changing economic fundamentals.

The inclusion of unrealized gains and losses in AFS securities would diminish the relevance and transparency of the Tier 1 capital measure due to institutions receiving inflated levels of Tier 1 capital from declining interest rates (and hence) rising market values of fixed rate, non callable securities. This change in capital could overstate the amount of Tier 1 capital if the subject bank had no intention of monetizing the gain on the securities; this could be the case in a scenario where economic activity is stagnant resulting in falling interest rates.

XII. Acquired Member Assets

We recognize that, as a conceptual matter, there may be some merit in the proposed rule's approach to RBC requirements for the mortgage programs that have been established by many of the FHLBanks whereby they acquire or fund conventional and government-insured residential mortgage loans originated and serviced by member institutions, known as Acquired Member Assets ("AMA") Programs. These programs operate under the names Mortgage Partnership Finance® ("MPF®") Program[28], first established in 1997, and the Mortgage Purchase Program ("MPP"), established in 2000. By using a unique risk-sharing structure, these programs allow participating members to retain a significant portion of the credit risk of the fixed-rate mortgages they originate when selling conventionally underwritten loans to the FHLBanks. Allocating the risks inherent in long term, fixed-rate mortgages in this manner results in a more efficient and lower cost mortgage financing benefitting American home buyers.

These programs are very popular with smaller community financial institutions because they provide an alternative to the traditional secondary market that can be difficult or prohibitively costly for many community lenders to access. Approximately 1,500 FHLBank member institutions, typically community banks, thrifts and credit unions, have used these programs to fund about $235 billion of mortgages that have helped home buyers in every state, including large numbers of low- and middle- income buyers, purchase a new home or lower the cost of their existing home through refinancing.

The structure of several MPF® products requires a participating member to provide a credit enhancement of a defined portion of a pool of residential mortgage loans that have been delivered to one of the FHLBanks. Even though the loans are held on the balance sheet of the FHLBank, the participating member must hold risk-based capital ("RBC") against its off-balance

[28] "Mortgage Partnership Finance" and "MPF" are registered trademarks of the Federal Home Loan Bank of Chicago.

sheet credit enhancement ("CE") obligation. As we understand the proposed rule, the amount of RBC required for participating members would be changed to more appropriately reflect the risk of potential losses related to the participating members' CE obligation.

Under the "standardized approach" described in the proposed rule, there are three possible definitional paths for a participating members' credit enhancement obligation in the AMA Programs: (1) "traditional securitization"; (2) "synthetic securitization"; and (3) "retail exposure." Based on our analysis, a member's credit enhancement required under the MPF® Program would likely fall into the "synthetic securitization" definition and resulting methodology.

The proposed rule eliminates the existing regulatory approach for RBC that has been in place since the MPF® Program was rolled out to members in 1997, replacing it with a much more conceptually appropriate, albeit complicated, formula. Further, the proposed rule would not grandfather existing MPF® pools under the current RBC rules.

Member credit support obligations in MPP programs are structured differently from those of MPF® products. Participating members' credit support obligations are limited to funding a risk based and FHLBank established Lender Risk Account ("LRA") from the proceeds of the sale of the mortgage loans (a purchase price hold-back) or a portion of the amount of interest paid by the borrower, and to providing supplemental mortgage insurance for some MPP products. Each MPP mortgage pool's LRA is used to reduce or offset credit losses suffered by the pool. No member is obligated to cover credit losses over and above the amount of funds in the LRA. Amounts remaining in the LRA after losses are returned to the participating member according to a predetermined release schedule. The participating member's exposure is therefore limited to the risk it will not receive all (or any) of the LRA, because the MPP FHLBank absorbs any losses in excess of the LRA. However, as in the case of the MPF® products, we understand that the proposed rule would not grandfather existing MPP pools under current RBC rules.

The Council recommends working toward a solution that implements the formula-based approach to determining the RBC requirement related to the member holding the CE obligation without requiring the risk weighting tied to Category 1 loans under the proposed rules. The formula-based approach could fit into the existing RBC framework that recognizes the safe and sound loans being sold into AMA Programs.

Modifying the proposed rule to more appropriately recognize the credit risk members accept by retaining a credit enhancement on high quality residential mortgages will encourage broader participation and the use of private capital to support the residential mortgage markets. However, the proposed rule's highly unfavorable treatment of mortgage servicing rights (as indicated in a previous section of this letter under the heading "VII. Mortgage Servicing Rights") would be very detrimental to the AMA programs, in which FHLBank member institutions generally retain servicing of the loans and thus maintain their relationship with their customers. Moreover, the rules should be simplified to more closely match the existing framework to reduce the risk that smaller community financial institutions might exit the mortgage origination market, which would further concentrate this market into the hands of a few, very large financial institutions and reduce choices for American consumers.

XIII. Disparate Competitive Impacts

One of the primary purposes of the Basel framework was to better align required capital and risk in order to reduce the competitive advantages that capital regulations could provide to different banking organizations. The same principle applies within a single country. When one segment of the financial services industry is required to hold capital that is in excess of the economic risk of its assets, the segments of the industry not burdened by these excessive capital requirements will have a market advantage. Thus it is critical that capital charges be closely aligned to the risk inherent in the portfolios and activities of the institutions subject to those charges.

As discussed above, we believe that the proposal will impose capital charges that are far in excess of the actual risks presented, especially for mortgages written since the financial crisis of 2008. As a result, non-regulated lenders will be able to gain market share at the expense of regulated banking institutions. Making this problem more severe, the bifurcated capital approach (standardized vs. advanced) creates the potential for significant disparate competitive impacts across the two approaches. The significant differences in capital requirements across the advanced and standardized approaches will almost certainly negatively impact community financial institutions as they compete with larger institutions in low credit risk portfolios like traditional mortgages.

XIV. Conclusion

The Council supports the efforts of the federal regulators to enhance regulatory capital requirements for insured depository institutions and their holding companies. However, overall we are unable to support these rules as proposed.

We believe that any increased risk weight must be appropriately aligned with the actual risk presented by the asset. High capital for non-traditional or poorly underwritten loans makes sense, and we support that policy. However, applying higher capital charges for traditional and prudently underwritten mortgages would be extremely counterproductive to our economy and to the American consumer. We therefore urge the regulators to evaluate carefully the need to increase the risk weight of Category 1 mortgages, and to take into account both current underwriting standards and the overlay of regulatory initiatives designed to assure prudent lending in the future.

The Council also urges the regulators to consider placing well underwritten balloon loans, made in rural or agricultural areas, into Category 1, as was done in the Dodd-Frank Act for QM loans.

The proposed increase in capital for high-volatility commercial real estate loans (HVCRE) is another area that should be reconsidered, in light of the changes in both regulatory oversight and the more recent performance of these loans. There is a great need for multi-family housing development, and increasing the capital requirements for these loans may have significant unintended consequences for this sector of the housing market.

Under the proposal, banking organizations would essentially be forced out of the market for mortgage servicing rights. We believe that this result is not in the public interest, and a better approach would be to link the treatment of mortgage servicing to the quality of the associated mortgage loans. For example, MSRs associated with loans meeting a QM standard should be afforded better treatment than other MSRs.

We also believe that the proposed treatment of mortgage securitization needs to be revised. Under the proposal, non-conforming loans would be particularly hard hit, since private label mortgage-backed securities would be significantly disadvantaged.

The Council believes that the higher capital required for reverse repurchase agreements and swap agreements that are not cleared should be revised to take into account situations where a FHLBank is a counterparty.

While as a conceptual matter there may be some merit in the proposed rule's approach to risk based capital requirements for the FHLBanks mortgage programs, known as Acquired Member Assets ("AMA") Programs, the proposed rule's highly unfavorable treatment of mortgage servicing rights would be very detrimental to the AMA programs. Moreover, the rule should be simplified to more closely match the existing framework to reduce the risk that smaller community financial institutions might exit the mortgage origination market, which would further concentrate this market into the hands of a few, very large financial institutions and reduce choices for American consumers.

The significant differences in capital requirements between the standardized and advanced approaches and the likely negative impact of this imbalance on community financial institutions also represent a significant concern. We suggest the standardized rule include a formal and scheduled recalibration of the standardized approach within the parallel reporting period of the advanced approach to achieve a greater degree of alignment and thereby eliminate significant competitive imbalances and other impacts detrimental to the safety and soundness of community financial institutions.

Finally, the proposed capital rule includes Accumulated Other Comprehensive Income (AOCI) in calculating Tier 1 capital. The inclusion of unrealized gains and losses on securities held as "available for sale" in determining Tier 1 capital has the potential to substantially increase the volatility of Tier 1 capital and distort the bank's regulatory capital ratios. Community banks holding interest rate sensitive securities for sound business purposes could see changes to their capital ratios based solely on interest rate changes rather than changes from credit quality.

We thank you again for the opportunity to comment on these proposals.

Sincerely,

Carl, Wick

Carl F. Wick
Chairman
Council of Federal Home Loan Banks

STATEMENT SUBMITTED BY THE INDEPENDENT COMMUNITY BANKS OF AMERICA

Basel III Should Exempt Community Banks

On behalf of its nearly 5,000 community bank members, ICBA is pleased to submit this statement for the record for the Senate Banking Committee hearing titled: "Oversight of Basel III: Impact of Proposed Capital Rules." We appreciate the opportunity to share the community bank perspective on this issue. ICBA urges the banking regulators to exempt all banks with less than $50 billion in assets from the proposed rules in order to avoid significant unintended consequences including further industry consolidation that would harm small business lending, consumers, and small communities.

ICBA supports strong capital requirements that will make the banking system more resilient and help deter another global financial crisis. However, Basel III and the standardized approach introduce drastic changes to both the definition and calculation of regulatory capital that will negatively impact a fragile housing recovery and the overall economy. For community banks, Basel III and the standardized approach are regulatory overkill and will have a devastating impact on small communities and rural areas.

ICBA strongly believes the complex risk weights and capital requirements of Basel III and the standardized approach should not be applied to financial institutions in the United States with consolidated assets of $50 billion or less. These institutions are not deemed to be systemically important financial institutions (SIFIs) under the Dodd-Frank Act and are not subject to enhanced prudential standards. Applying Basel III and the standardized approach to banks beneath this threshold will lead to large scale consolidation in an industry already overly concentrated. Without a vibrant community banking system, consumers will be left with fewer choices and communities and rural areas across the country will be deprived of the credit needed to sustain and grow local economies.

Absent a total exemption, ICBA strongly favors the following modifications to Basel III to simplify the rule and better align the proposed capital standards to the unique strengths and risks of community banking:

- Banks under $50 billion in assets should be exempt from the standardized approach for risk-weighted assets. The standardized approach's complex and punitive risk weighting for residential mortgages could force community banks out of this line of business.
- Unless it can be empirically shown that these assets are risky, the proposed substantially higher risk weights for balloon mortgages and second mortgages should be reduced to their current Basel I levels. Basel I risk weighting better reflects the high-quality nature of this asset class.
- Accumulated other comprehensive income (AOCI) should continue to be excluded from the calculation of regulatory capital for banks under $50 billion in assets to avoid harmful and unnecessary volatility in capital adequacy.
- If AOCI is not excluded from the calculation of regulatory capital for community banks, then changes in the fair value of all obligations of the U.S. Government, mortgage-backed securities issued by Fannie Mae and Freddie Mac, and all municipal securities should be exempt.
- Consistent with the Collins Amendment of the Dodd-Frank Act, bank regulators should continue the current Tier 1 regulatory capital treatment of TruPS issued by bank holding companies with consolidated assets between $500 million and $15 billion. This change would reflect Congressional intent and reduce the capital burden for community banks.
- Consistent with the proposal for bank holding companies, the Federal Reserve should exempt all thrift holding companies with assets of $500 million or less from Basel III and the standardized approach or provide a policy rationale for why they are not exempt.
- The allowance for loan and lease losses (ALLL) should be included in Tier 1 capital in an amount up to 1.25 percent of risk-weighted assets and the remaining balance of ALLL should qualify for inclusion in Tier 2 capital so that the entire ALLL will be included in a community bank's total capital. This treatment will give proper recognition to the loss-absorbing capacity of the ALLL.
- Mortgage servicing assets should be subject to the current higher deduction thresholds because they do not pose a risk to community bank capital.
- Community banks should be exempt from the provisions of the capital conservation buffer. This is particularly important for Subchapter S banks. Alter-

natively, the phase-in period for the capital conservation buffer should be extended by at least 3 years to January 1, 2022, to provide community banks with enough time to meet the new regulatory minimums.

- The proposed risk weights for equity investments should be substantially simplified so community banks will not be discouraged from investing in other financial institutions such as banker's banks, which are key business partners in community bank lending.
- In the absence of a full exemption from the standardized approach, any changes to the risk weights should be applied prospectively to give community banks enough time to comply.
- Regulators should make accommodations to ensure Basel III and the standardized approach do not negatively impact the Nation's minority banks and the diverse communities they serve. Minority banks should be preserved and promoted.
- If Basel III and the standardized approach are to apply to community banks, then they should also apply to credit unions to limit their competitive advantage.

Again, the most sensible and prudent policy, the policy that would avoid severe unintended consequences, would be an outright exemption for financial institutions with assets of less than $50 billion. Basel III was originally intended to apply only to large, complex, and internationally active institutions. Applying Basel III more broadly in a one-size-fits-all manner would harm all consumers and businesses that rely on credit and the impact would be especially harsh in small communities and rural areas not served by larger institutions.

ICBA encourages this Committee to consult our October 22 comment letter to the banking regulators for more detail substantiating the above views. (The ICBA letter is available at: *http://www.icba.org/files/ICBASites/PDFs/cl102212.pdf.*)

ICBA thanks this Committee for convening this important hearing and helping to raise the profile of a significant economic policy issue with far reaching implications. We appreciate the opportunity to present the views of the community banking industry.