SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

December 26, 2017

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AE59

Office of the Comptroller of the Currency (OCC)
400 7th Street SW., Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
Docket ID OCC-2017-0018

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
RIN 3064-AE59

Re: *Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*

Dear Sir or Madam,

The Conference of State Bank Supervisors (CSBS) appreciates the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC's), the Board of Governors of the Federal Reserve System's (FRB's), and the Office of the Comptroller of the Currency's (OCC's) (collectively, "the Agencies") joint Notice of Proposed Rulemaking (NPR, proposal, or proposed rule) to simplify certain aspects of the agencies' risk-based and leverage capital rules, entitled "Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996."

State bank regulators appreciate the agencies' recognition of the need to reduce the regulatory compliance burden imposed by the regulatory capital rules as revised in 2013. The proposed revisions are certainly intended to produce meaningful simplification of the regulatory capital rules, and may indeed do so for the limited number of institutions impacted by the proposed revisions. However, given the limited scope and impact of the proposed rule, state bank regulators continue to believe that more fundamental, comprehensive simplification of the regulatory capital rules is warranted.

The staggering complexity of the current regulatory capital rules imposes an unsustainable burden on community banks. Accordingly, in this letter, we recommend that the agencies develop a simplified capital framework for non-complex banking organizations by simplifying the methodology for calculating risk-weighted assets. While we would prefer to retain and simplify the risk-based capital adequacy standards, we would potentially support a simplified capital framework that relied solely on leverage-based capital adequacy standards for non-complex firms.

In Part I of this letter, we discuss our perspective on alternative simplification proposals, including how the agencies should simplify the calculation of risk-weighted assets and whether the agencies should rely solely on a leverage ratio in assessing capital adequacy. Then, in Part II, we address the proposed rule specifically and request clarification and modification of certain aspects of the proposed revisions to the capital rules.

I. THE AGENCIES SHOULD DEVELOP A SIMPLIFIED CAPITAL FRAMEWORK TAILORED TO THE COMPLEXITY AND RISK PROFILE OF NON-COMPLEX BANKING ORGANIZATIONS.

State bank regulators appreciate the agencies' request for comment on more comprehensive alternatives to simplify and streamline the regulatory capital rules. In response to this request, we recommend that the agencies develop a simplified capital framework tailored to the complexity and risk profile of non-complex banking organizations. Given the important role of leverage measures of capital adequacy in the supervisory process, in our view, a simplified capital framework for non-complex institutions could employ one of three alternative measurements of capital adequacy: (1) a risk-based ratio (that maintains a leverage requirement); (2) a simple leverage ratio; or (3) a modified leverage ratio that incorporates certain off-balance sheet exposures.

The first alternative would combine a risk-based ratio with a leverage ratio and thus retain much of the current regulatory capital requirements while tailoring the structure of the risk-based capital rules to the complexity and risk-profile of non-complex institutions. The second option would use only a simple leverage ratio to measure the capital adequacy of non-complex institutions and such institutions would no longer be required to comply with the risk-based capital framework. The third alternative would measure capital adequacy through a modified leverage ratio that accounts for certain off-balance sheet exposures not captured by the simple leverage ratio and would no longer measure capital adequacy through a risk-based capital ratio.

Ultimately, state bank regulators would prefer that the agencies pursue the first option by maintaining the current minimum leverage and risk-based capital requirements while comprehensively simplifying the risk-based capital rules for non-complex institutions. We believe that the risk-based capital rules, particularly the standardized approach for risk-weighted assets, can be simplified in a manner that will minimize burden while ensuring that capital remains at prudent levels among non-complex banking organizations. In Section A, we discuss several aspects of the risk-based capital rules that may be simplified without compromising the safety and soundness of non-complex institutions or the banking system.

Although we would prefer to maintain risk-based capital requirements, state bank regulators would potentially support the development of a leverage-based capital adequacy framework if such a framework employed either a modified leverage ratio or, alternatively, a simple leverage ratio with eligibility limited to institutions that do not conduct significant off-balance sheet and nontraditional activities. In Section B, we discuss how a leverage-based capital adequacy framework could potentially be structured without compromising the safety and soundness of non-complex institutions or the banking system.

Of course, the appropriate capital framework for a non-complex institution depends partly on the criteria chosen to assess complexity or risk in determining eligibility for using the simplified capital framework. Accordingly, in Section C, we provide our perspective on considerations that should be made in defining a non-complex institution in light of the nature of the institution's activities and risk profile.

A. <u>To create a simplified capital framework, the agencies should develop a simplified standardized approach which is proportional to the risk profile of non-complex banking organizations.</u>

State bank regulators believe that the risk-based capital rules can be simplified in a manner that will neither reduce their risk-sensitivity nor reduce the quantity and quality of capital in the banking system. Since, based on our experience, the greatest source of complexity and burden in the current risk-based capital rules stems from the standardized approach for measuring risk-weighted assets, the greatest marginal gains in terms of simplification can be achieved through revisions to the standardized approach. Thus, state bank regulators recommend that the agencies substantially revise the current standardized approach by developing a simplified standardized approach which is proportional to the complexity and risk profile of non-complex institutions.

In this Section, we first provide background on the revisions to the regulatory capital rules in 2013 and our position with respect to those revisions. Then, we assess the impact and efficacy of the revisions to the standardized approach in light of the complexity and burden introduced into the risk-based capital rules thereby. Based on this assessment, we recommend the development of a simplified standardized approach for non-complex institutions and provide several examples of revisions that could be made towards this end.

1. *<u>State bank regulators supported revising the regulatory capital rules to raise the quality and quantity of capital in the banking system but opposed the application of the Basel III standardized approach to smaller, non-complex banking organizations.</u>*

In 2012, the agencies proposed comprehensive revisions to the then-applicable regulatory capital rules to incorporate changes made to the Basel capital framework, including those in "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III), and to implement relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA). The then-applicable general risk-based and leverage capital rules were substantially revised through three concurrent notices of proposed rulemaking (NPR) which restructured the agencies' capital rules into a harmonized, codified regulatory capital framework.[1]

In commenting on the proposed capital rules, state bank regulators expressed our support for the goal of enhancing the quality and quantity of capital in the banking system.[2] However, we opposed the proposed revisions to the standardized approach for calculating risk-weighted assets (Basel III standardized approach) due to its staggering complexity and failure to increase the risk-sensitivity of the capital rules for community banks.[3] These shortcomings, we argued, were largely a product of the NPR incorporating aspects of the Basel II advanced approach rules which were intended to apply only to large, internationally active banking organizations. For this reason, State bank regulators expressed our view that community banks should be excluded from the scope of the proposed standardized approach and that

[1] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52792 (Aug. 30, 2012); Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52888 (Aug. 30, 2012); Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule, 77 Fed. Reg. 52978 (Aug. 30, 2012).

[2] *See* CSBS comment letter on the Basel III NPR, available here: https://www.csbs.org/sites/default/files/2017-11/CSBSBaselIIIletterFinal.pdf.

[3] *See* CSBS comment letter on the Standardized Approach NPR, available here: https://www.csbs.org/sites/default/files/2017-11/CSBSStandardizedApproachletterFinal.pdf.

efforts to enhance the risk-sensitivity of the capital rules should be pursued by establishing a standardized approach appropriately tailored to the complexity and risk profile of community banks.

Although, in finalizing the proposed rules in 2013, the agencies made several modifications to simplify the proposed rules, substantial complexity remained. Ultimately, the agencies did not modify the scope of the rules' coverage, the finalized regulatory capital rules were established as the generally applicable capital requirements for all banking organizations (Basel III capital rules), and community banks became subject to the same requirements that apply to the large, internationally active banking organizations. Nevertheless, State bank regulators continue to believe that the Basel III capital rules should not apply to small, non-complex banking organizations. For this reason, we urge the agencies to pursue a more fundamental, comprehensive simplification of the Basel III capital rules than that contemplated by the revisions in the current proposed rulemaking.

2. *The Basel III standardized approach introduced significant complexity and burden without increasing the risk-sensitivity of the regulatory capital rules for non-complex institutions.*

The primary goal in establishing the Basel III standardized approach was to enhance the risk-sensitivity of the measurement of a banking organization's risk-weighted assets. In general, capital requirements are made more risk-sensitive by providing for greater differentiation in the assessment of credit risk for assets and exposures. Although greater risk-differentiation results in greater complexity in applying capital requirements, it also can enhance the risk-sensitivity of the rules and thereby produce benefits which counter-balance the costs of the heavier compliance burden. As discussed below, the greater risk-differentiation introduced through the Basel III standardized approach did not increase the risk-sensitivity of the capital rules for non-complex institutions, and accordingly, imposed the costs of complexity on these institutions without simultaneously providing such institutions with the benefits of enhanced sensitivity.

The Basel III standardized approach was said to be more risk-sensitive than the Basel I standardized approach because it introduced enhanced risk-differentiation by providing for greater granularity in the classification of exposures and greater variability in the application of risk weights thereto. For instance, under the Basel I standardized approach, five risk weights applied across 20 exposure categories, whereas, under the Basel III standardized approach, 16 risk weights apply across 32 exposure categories. This heightened risk differentiation, of course, created greater operational complexity and compliance burden for all institutions, but it did not, in the case of non-complex institutions, simultaneously increase the risk-sensitivity of the capital rules.

The increasingly granular classification and risk weighting of off-balance sheet exposures did not result in the Basel III standardized approach being any more risk-sensitive for non-complex institutions relative to the Basel I standardized approach. Indeed, with the exception of past due exposures and high-volatility commercial real estate (HVCRE) exposures, nearly all of the assets and exposures of smaller banking organizations are subject to the same risk weights that applied under the Basel I standardized approach.[4] Thus, although the new exposure categories established under the Basel III standardized approach enabled greater risk-differentiation among those exposures, this did not result in the Basel III capital rules being

[4] Certainly, some of the new exposure categories and risk weights introduced under the Basel III standardized approach—such as those for past due exposures and HVCRE—increased the risk-sensitivity of the capital rules for non-complex institutions. State bank regulators believe, however, that the standardized approach could be comprehensively simplified while retaining the differentiation and heightened risk weights for HVCRE and past due exposures.

more risk-sensitive for non-complex institutions because such institutions simply do not have those exposures to which the standardized approach was made more sensitive.

Nevertheless, the Basel III standardized approach is still a significant source of compliance burden even for banks with little or no holdings within the new exposure categories or subject to the new risk weights. Such burden comes not only in the form of initial implementation costs related to establishing new systems and hiring and training additional personnel, but also ongoing compliance costs in obtaining additional information related to certain exposures and maintaining the requisite expertise to ensure that items are classified, measured, weighted and reported in a manner that both complies with the rules and is most advantageous to the institution. Additionally, the sheer complexity of the capital rules complicates the evaluation of asset allocation strategies and may cause smaller, non-complex institutions to forego advantageous opportunities due to the uncertainty surrounding their treatment under the Basel III capital rules.

Since the Basel III standardized approach did not increase the risk-sensitivity of the capital rules for non-complex institutions, and since the associated complexity of the capital rules imposes significant burdens and costs on such institutions, state bank regulators believe that the agencies should significantly revise the Basel III standardized approach by developing a "simplified standardized approach" for non-complex banking organizations.

3. *To achieve comprehensive simplification of the capital rules, the agencies should develop a simplified standardized approach for risk-weighted assets for non-complex institutions.*

To comprehensively simplify the regulatory capital rules, state bank regulators recommend the development of a "simplified standardized approach" which, in determining risk-weighted assets, would be more sensitive to those risks, and only those risks, to which non-complex institutions are routinely exposed. To minimize any initial implementation costs for non-complex institutions, a simplified standardized approach should be developed by using the Basel III standardized approach as a baseline and reassessing the efficacy and proportionality of the new exposure categories and new risk weights established thereunder.

The new Basel III exposure categories and risk weights should not be retained in a simplified standardized approach if non-complex institutions do not routinely engage in significant levels of activities captured by the new exposure categories and risk weights. The increasingly granular categorization and treatment of exposures is unnecessary in such cases for it simply provides for greater risk-differentiation without enhancing the risk-sensitivity of the capital rules. Thus, if non-complex banking organizations do not have a significant level of exposures within or subject to the new Basel III exposure categories or risk weights, then a simplified standardized approach should not differentiate these exposure categories or apply distinct risk weights thereto.

The less granular classification and risk weighting of these exposures under a simplified standardized approach would not reduce the quantity of capital held by non-complex institutions. For instance, given that smaller, non-complex banking organizations do not have significant levels of equity exposures, eliminating the differentiated treatment of equity exposures or the heightened risk weights applicable thereto would not reduce the quantity of capital held by or the safety and soundness of non-complex institutions.[5]

[5] It is noteworthy that the elimination of the heightened risk weights of 300, 400 and 600 percent that are currently applied to equity exposures would not have materially reduced the quantity of capital required to be held by small,

On the other hand, a simplified standardized approach should retain and simplify the new Basel III exposure categories and risk weights if non-complex institutions routinely engage in significant levels of activities captured by the new exposure categories and risk weights. Since greater differentiation in the treatment of these exposures enhances the risk-sensitivity of the capital rule for non-complex institutions, the methodology for risk-weighting these exposures should be simplified to the greatest extent possible while maintaining comparable levels of risk-sensitivity. Thus, if non-complex institutions have a significant level of exposures to any new Basel III exposure categories or risk weights, then a simplified standardized approach should provide a simpler methodology for risk-weighting such exposures.

For instance, in lieu of requiring the application of the gross-up approach, simplified supervisory formula approach, or dollar-for-dollar capital approach to on-balance sheet securitization exposures, the agencies could permit non-complex institutions that only assume the role of an "investing bank" in a traditional securitization to apply a significantly lower, uniform risk weight to any on-balance sheet securitization exposures arising therefrom.[6] Since an investing bank does not originate the credit exposures underlying the securitization or otherwise provide credit enhancement, liquidity facilities or other financial support to a securitization, permitting the application of a standard, lower risk weight to on-balance sheet securitization exposures would not reduce the safety and soundness of a non-complex institution acting solely in the capacity of an investing bank.

Furthermore, we encourage the agencies to focus especially on those aspects of the Basel III standardized approach which govern the measurement of risk-weighted assets for exposures other than general credit risk exposures (such as the rules applicable to securitization exposures, equity exposures and unsettled transactions) or which cover a significantly broader class of exposures relative to their treatment under Basel I (such as the rules applicable to repo-style transactions and derivatives transactions). The distinct treatment of and methodologies applicable to these exposure categories generally derive from rules which were originally developed under the advanced approach or market risk frameworks and, accordingly, were calibrated to the risk profiles and relative complexity of large, internationally active banks. As discussed above, we do not believe that small, non-complex institutions should be subject to capital rules that were originally developed and designed to apply to large, complex banking organizations.

Lastly, we encourage the agencies to reevaluate the treatment of past due exposures under the Basel III standardized approach. The Basel III standardized approach imposes a heightened risk weight of 150 percent to certain exposures that are 90 days or more past due or on nonaccrual. While the heightened risk weight increased the risk-sensitivity of the capital rules, state bank regulators opposed this treatment of past due exposures because it is procyclical and burdensome for community banks. In light of the forthcoming shift from an incurred loss to a current expected credit loss (CECL) model, the capacity of allowance for loan and lease losses (ALLL) to cover expected losses will be enhanced. Since, under CECL, banking organizations will have improved their estimation and coverage of expected losses, state bank regulators believe the agencies should reevaluate whether a heightened capital charge to cover unexpected losses on past due exposures is still warranted.

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non-complex banking organizations since the effective date of the Basel III capital rules. Moreover, eliminating the equity exposure category itself by treating all equity exposures as corporate exposures would have actually increased minimum capital requirements over this period.

[6] This simplified treatment of the securitization exposures of investing banks was originally contemplated in the Basel II framework as part of a simplified standardized approach. *See* BCBS, "International Convergence of Capital Measurement and Capital Standards: A Revised Framework," Annex 11, (June 2006), *available at* http://www.bis.org/publ/bcbs128.htm.

In sum, state bank regulators believe that the development of a simplified standardized approach for non-complex banks along these lines would significantly reduce the burdens stemming from the Basel III capital rules, while ensuring that prudent levels of capital are maintained among non-complex banking organizations.

B. The agencies should consider developing an alternative leverage-based capital adequacy framework if necessary to achieve comprehensive simplification of the capital rules.

State bank regulators recognize the supervisory value of risk-based capital standards in assessing capital adequacy of and comparing relative risks among banking organizations. Although we would prefer the retention and comprehensive simplification of the risk-based capital rules, we would potentially support the establishment of a leverage-based capital adequacy framework employing a higher minimum leverage ratio. Of course, the desirability of a leverage-based capital adequacy framework would ultimately depend on the design and structure of such a framework. Nevertheless, we would like to outline our perspective on the appropriate definition and level of a leverage ratio under such a framework.

As discussed above, a leverage-based capital adequacy framework could employ either a simple leverage ratio or a modified leverage ratio. Using only a simple leverage ratio to measure the capital adequacy of non-complex institutions would amount to a significant reduction of complexity and compliance burden, since such institutions would no longer be required to comply with the risk-based capital framework. Additionally, a simple leverage ratio would be relatively more transparent and reliable since it provides a simple, straightforward measure of capital relative to total assets. However, utilizing a simple leverage ratio would also raise serious prudential and supervisory concerns because it does not adequately account for off-balance sheet exposures and it could create incentives for institutions to avoid investing in low-risk assets.

To ameliorate these concerns, a leverage-based capital adequacy framework could employ a modified leverage ratio that accounts for certain off-balance sheet exposures not captured by the simple leverage ratio. A modified leverage ratio would incorporate the simplicity of the leverage ratio while seeking to remedy its main weaknesses by adding the exposures arising from loan commitments and other off-balance-sheet transactions to total bank assets. A disadvantage of the modified leverage ratio is that, unlike the risk-based approach, it would provide no capital benefit to banking organizations that maintain a low-risk profile and might create the same perverse incentives to risk-up balance sheets.

State bank regulators would potentially support the development of a leverage-based capital adequacy framework employing either a modified leverage ratio or, alternatively, a simple leverage ratio that may only be used by banking organizations that do not conduct significant off-balance sheet activities and that are not engaged in significant nontraditional activities. If a simple leverage ratio is utilized, the agencies should employ concentration and/or growth triggers in defining significant off-balance sheet and non-traditional activities to screen out complex or high-risk profile banking organizations from the simplified capital framework. Any perverse incentives created under a leverage-based capital adequacy framework can potentially be mitigated through the application of appropriate focus and scrutiny in the supervision and examination of non-complex banking organizations.

As to the appropriate level of the minimum capital ratio under a leverage-based capital adequacy framework, obviously, the minimum required ratio would need to be meaningfully increased relative to its level under the Basel III capital rules. State bank regulators believe that the level should be calibrated to ensure the continued strength and resiliency of non-complex banking organizations by continuing to require a high quantity of capital. At the same time, we urge the agencies to take into account the relative stringency of leverage and risk-based capital requirements in the calibration process given that, all else being equal, a leverage ratio generally demands a higher quantity of capital than a risk-based capital ratio.

Under both the Basel I and Basel III standardized approaches, risk-weighted asset density (the ratio of risk-weighted assets to total assets) for the vast majority of banking organizations generally falls within a range of 60 to 80 percent. Furthermore, if it were instituted today, the pre-Basel I minimum capital adequacy requirement (a six percent Tier 1 leverage ratio) would be the "binding constraint" for virtually all banking organizations.[7] Thus, state bank regulators believe that the minimum amount of capital required under a leverage-based capital adequacy framework should take into account the relative stringency of leverage and risk-based capital requirements while ensuring that prudent levels of capital are maintained by non-complex banking organizations.

Since a leverage-based capital adequacy framework would be vastly simpler and less burdensome from a compliance perspective and could potentially be appropriately calibrated to maintain a high quality and quantity of capital in the banking system, state bank regulators would potentially support the establishment of a leverage-based capital adequacy framework for non-complex institutions. We believe such a framework should employ either a modified leverage ratio or, alternatively, a simple leverage ratio that may only be used by banking organizations that do not conduct significant off-balance sheet activities and that are not engaged in significant nontraditional activities. Although we would potentially support the development of a leverage-based capital adequacy framework, state bank regulators would prefer to retain and comprehensively simplify the current risk-based capital rules, as outlined above, in order to render them proportional to the complexity and risk-profile of non-complex institutions.

C. The agencies should permit only non-complex banking organizations to operate under a simplified capital framework with the complexity of an institution determined according to its activities and its risk profile.

The appropriate capital framework for a non-complex institution depends partly on the criteria defining what constitutes a non-complex institution. Since the benefits of a leverage-based approach or a simplified, standardized approach will likely be enhanced if banking organizations with significant off-balance sheet exposures or engaged in significant amounts of non-traditional activities are screened out of the simplified capital framework, state bank regulators believe that the application of a simplified capital framework to large, complex banking organizations would not be appropriate.

To limit eligibility for a simplified capital framework, we encourage the agencies to develop an activity-based definition of what constitutes a "non-complex banking organization", utilizing the FDIC research definition of "community banking organization" with certain adjustments to incorporate screening criteria for off-balance sheet exposures and non-traditional activities.[8] A non-complex banking organization would generally have a relatively simple and low-risk balance sheet; a moderate level of off-balance sheet activity that is compatible with core business activities; and relatively little involvement in nontraditional

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[7] A leverage or risk-based capital ratio is the "binding constraint" if the minimum leverage or risk-based capital requirement, respectively, would be the first to be violated if the banking organization's capital were reduced. Here, we compare a hypothetical minimum tier 1 leverage ratio of six percent with the minimum tier 1 risk-based capital ratio necessary to be "adequately capitalized" under the prompt corrective action framework (i.e. 6 percent).

[8] *See* FDIC Community Banking Study (December 2012), *available here* https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.
The agencies have previously contemplated developing a simplified capital framework for non-complex institutions and establishing a definition of non-complex institution for this purpose. *See* Simplified Capital Framework for Non-Complex Institutions, 65 Fed. Reg. 66193 (Nov. 3, 2000).

activities as a source of income. Factors considered when assessing an institution's overall risk profile could include the level of involvement in activities that present greater degrees of credit, liquidity, market, or other risks, such as sub-prime lending activities, significant asset securitization activities, or trading activities.

We encourage the agencies to consider and solicit public input on both the range of alternative approaches to creating a simplified capital framework for non-complex banking organizations as well as the possible criteria that could be used to determine whether an institution could be considered a non-complex banking organization. Ultimately, state bank regulators believe that, if the eligibility for a simplified capital framework is appropriately limited, then its application should not reduce the strength, resiliency or capital adequacy of the U.S. banking system.

II. THE AGENCIES SHOULD CLARIFY AND/OR MODIFY THE PROPOSED TREATMENT OF HVADC EXPOSURES AND THE REVISED TREATMENT OF UFI INVESTMENTS.

State bank regulators appreciate the agencies' recognition of the need to reduce the regulatory compliance burden stemming from the Basel III capital rules, particularly for community banks. Although, as discussed in Part I, we believe that more comprehensive simplification of the Basel III capital rules is warranted, we certainly view the proposed rule as a positive first step in the path towards reducing the burden of the capital rules for community banks.

Nevertheless, state bank regulators wish to address certain aspects of the proposed revisions which we believe require further clarification or warrant slight modification. Specifically, we request that the agencies amend certain requirements applicable to the newly defined exposure category called high volatility acquisition, development, or construction (HVADC) exposure and clarify the treatment of non-advanced approaches banks' investments in unconsolidated financial institutions (UFI investments).

A. The agencies should reduce the compliance burden created under the new HVADC exposure framework by clarifying and/or modifying the documentation requirements applicable thereto.

The proposed capital rule replaces the HVCRE exposure category with a newly defined exposure category that would apply to credit facilities that finance HVADC exposures. The proposed HVADC exposure definition likely would capture more acquisition, development, or construction exposures than are currently captured by the definition of HVCRE exposure. Given the broader scope of the proposed definition, HVADC exposures would receive a 130 percent risk weight—a reduction from the 150 percent risk weight currently applied to HVCRE. Although state bank regulators appreciate interagency efforts to simplify the HVCRE definition, we believe that aspects of the proposed HVADC definition warrant modification and further clarification, such as the "primarily finances" test and associated documentation requirements.

To determine if an exposure falls within the proposed HVADC definition, the Agencies' have proposed a "primarily finances" test requiring that at least 50% of loan proceeds be used for covered activities for a credit facility to be considered HVADC. To determine if a loan meets the "primarily finances" test, the Agencies recommend that institutions engaging in HVADC transactions develop processes to document and review the intended use of the loan proceeds. State regulators are concerned that the additional documentation required to define HVADC may impose significant compliance burden on smaller and less complex banks. Community banks play an outsized role in commercial real estate lending. As of

2017:Q2, 24 percent of community banks held a commercial real estate lending specialization.[9] The HVADC definition is expected to cover a broader range of exposures than HVCRE, and because of the outsized role community banks play in this space, increased documentation requirements could pose significant burden.

Accordingly, we request clarity on whether supporting documentation is to only be generated at the origination of the loan, or if institutions are expected to periodically review the use of the loan proceeds. Additionally, state regulators recommend that, for certain HVADC exposures, the agencies apply an exemption from documentation requirements for community banks under certain circumstances. We believe that an appropriately tailored exemption could be used to apply substantially lower documentation requirements and ultimately lighten the compliance burden for smaller and less complex institutions.

B. The agencies should clarify the eligibility of the UFI investments of non-advanced approaches banks for the preferential 100 percent risk weight under the equity exposure framework.

The Basel III capital rules currently provide distinct treatment of "significant investments" in the capital of UFIs and "non-significant investments" in the capital of UFIs for purposes of calculating regulatory capital and risk-weighted assets. For non-advanced approaches banking organizations, the proposed rule removes the distinct treatment currently applicable to different categories of UFI investments depending on their significance and form. Instead, the proposed rule would apply a single definition of UFI investments, consolidate the different deduction treatments for UFI investments, and eliminate the exclusion of significant UFI investments from eligibility for the preferential 100% risk weight.

State bank regulators request clarification that non-advanced approaches banks would still be eligible to apply the preferential risk weight of 100 percent to their UFI investments that qualify as non-significant equity exposures under Section .52(b)(3)(iii) of the capital rule. The proposed rule does not amend this particular provision. Since this provision currently applies to equity exposures that are not significant UFI investments, and since non-advanced approaches banks would, by definition, not have significant equity exposures, the language of this provision gives rise to an inference that the UFI investments of non-advanced approaches banks would not be eligible for the preferential 100 percent risk weight. Accordingly, state bank regulators request further clarity as to the eligibility of the UFI investments of non-advanced approaches banks for the preferential 100 percent risk weight under the equity exposure framework.

III. CONCLUSION

State bank regulators support the agencies' efforts to simplify the risk-based capital rules and their willingness to solicit feedback on alternative approaches to achieve comprehensive simplification of the Basel III capital rules. The complexity of the Basel III capital rules currently imposes an unsustainable compliance burden on community banks. We believe that comprehensive simplification of the risk-based capital rules is attainable by substantially revising the Basel III capital rules to develop a simplified capital framework proportional to the complexity and risk profile of non-complex banking organizations.

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[9] *See* FDIC, Statistics on Depository Institutions, Second Quarter 2017. The FDIC considers a community bank to have a Commercial Real Estate Lending Specialization if C&D loans are more than 10% of assets, or CRE loans are more than 30% of total assets.

Given that true simplification would require significant revisions to the current regulatory capital rules, state bank regulators encourage the agencies to solicit input from the industry and other stakeholders through an advanced notice of proposed rulemaking to gauge the relative interest in and to prompt deliberation of the costs and benefits of the alternative simplification proposals. We appreciate the opportunity to comment on the proposed revisions and look forward to engaging in future efforts to simplify the regulatory capital rules in a manner that ensures the continued strength and resiliency of the banking system while significantly reducing the compliance burden imposed on community banks.

Sincerely,

John Ryan