CSBS SINCE 1902

CONFERENCE OF STATE BANK SUPERVISORS

October 17, 2012

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

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington DC, 20219
Docket ID OCC-2012-0008

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

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 implement the Basel III capital accords, entitled *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action.*

In our view, the proposed rule is one of the most significant public policy matters facing the financial sector. The appropriate level of capital should enhance the resiliency of the banking sector, allowing institutions to remain solvent through the economic cycle. However, too much capital can have undesirable effects on the industry. Too much capital can have the effect of increasing management's tolerance for risk as they strive to provide a return for stockholders. An overly restrictive capital requirement also serves as a barrier to entry, discouraging capital from entering the banking system and further driving industry consolidation. It is critical to strike the appropriate balance to achieve a stable banking system, which is attractive to capital, and can serve as the backbone to a vibrant and diverse economy. This comment period provides a critical opportunity for the public to express its views on the proposed rules and the potential impact they will have on banks, credit availability, and economic growth. We encourage the Agencies to consider not only the calibration of capital requirements to ensure a resilient banking system, but also what is in the best interest of both the national and local economies. Capital requirements must factor in the existence of an active supervisory function and a resolution regime, which works as designed for the vast majority of banks.

We have provided feedback on the Agencies' Standardized Approach proposed rule in a separate comment letter. Our comments on the Basel III proposed rule are organized in the sections below.

Introduction

We support the Agencies' efforts to increase the minimum required capital. However, we are concerned with the ability to achieve this under the Basel III umbrella. The international agreement clearly states it is intended to cover the same institutions covered under Basel II,[1] which targets only large, internationally active banks. The agreement was never intended to apply to all U.S. banks. We recommend the Agencies scale back this rulemaking to apply only to the intended institutions. We would support a separate rulemaking to address the minimum capital requirements for banks not covered by Basel II and Basel III. The proposed rule should be appropriately calibrated to enhance stability while serving to attract capital to the system. The proposed rule must be easy to understand and simple to manage. We believe the public comments to this rulemaking will provide the Agencies sufficient feedback to effectively structure a new proposal.

Minimum Capital Ratios

CSBS generally supports a higher level of high quality capital at banking organizations. The financial crisis clearly demonstrated that capital levels meeting minimum capital requirements for regulatory purposes are not adequate for practical purposes during stressful conditions. Considering the experience of the US financial crisis, the Agencies have proposed to introduce higher minimum capital requirements for banking organizations.

Specifically, the Agencies have proposed to eliminate the exception for CAMELS 1 rated institutions to maintain a Tier 1 Leverage Ratio of 3%. All institutions will now have to adhere to a Tier 1 Leverage Ratio of 4%. CSBS supports a higher minimum Tier 1 Leverage Ratio. Practically, 4% is not an adequate level of operating capital for all institutions. We support the Agencies' comments regarding the need for institutions to hold capital commensurate with the risks and complexity of their business activity, regardless of the regulatory capital ratios.

Additionally, the Agencies have proposed a new Tier 1 Common Equity Capital ratio. Institutions would have to maintain a minimum Tier 1 Common Equity ratio of 4.5% to meet minimum capital requirements. CSBS supports a renewed focus on common equity, as this is the strongest form of capital. Community banks typically hold a higher percentage of common equity than larger institutions. A new common equity ratio should contribute to a more level playing field between community banks and large banks. As discussed further below, we do not support the proposal to include unrealized gains and losses on available for sale securities

[1] Basel III: A global regulatory framework for more resilient banks and banking systems, December 2010, page 11.

in the definition of Tier 1 Common Equity. Nevertheless, we generally support the common equity ratio and believe it will enhance the quality of capital positions across the industry.

For Tier 1 Risk-Based Capital, the Agencies have proposed to increase the minimum ratio from 4% to 6%. We support the increase in Tier 1 Risk-Based Capital. The Agencies have not proposed to adjust the current Total Risk-Based Capital Ratio of 8%.

Capital Conservation Buffer

The Agencies have proposed that institutions hold a capital conservation buffer comprising common equity tier 1 capital. The buffer represents an additional 2.5% of total risk-weighted assets. The buffer must be maintained to avoid restrictions on capital distributions and certain discretionary bonus payments. This has the effect of increasing the minimum risk based capital ratios by 250 basis points.

While we support requiring greater amounts of high quality capital, to the extent the capital conservation buffer introduces undue operational complexity for institutions, we believe regulators should work to clarify expectations. As discussed further in the Prompt Corrective Action (PCA) section of this letter, the number of consequential capital ratios detailed in the proposal to which institutions would have to adhere would introduce undue complexity to the capital planning process for banking organizations.

Countercyclical Capital Buffer and Supplemental Ratio

The Agencies have proposed to implement the Basel III countercyclical capital buffer for advanced approaches institutions, which generally includes institutions with assets above $250 billion. The countercyclical capital buffer would be based on detailed market indicators and would require larger institutions to hold up to 2.5% of additional risk-based capital. CSBS supports the Agencies' proposal to apply the countercyclical capital buffer only to institutions with assets above $250 billion. Larger institutions have greater access to capital markets, which will allow them to more reasonably meet the requirements of the countercyclical buffer. We also support the theoretical structure of the countercyclical capital buffer as it applies to advanced approaches institutions.

Additionally, advanced approaches institutions would be required to maintain a supplementary leverage ratio of tier 1 capital to total leverage exposure of 3%. We support the supplementary leverage provision. However, the off-balance sheet exposures and repo style transactions the Agencies site in support of this requirement occur frequently at large institutions that do not meet the advanced approaches criteria. The Agencies may consider application of the supplementary leverage ratio to classes of institutions with assets below $250 billion but not less than $50 billion on a case by case basis.

Prompt Corrective Action

The Agencies have proposed a method for incorporating changes to minimum capital ratios in the Prompt Corrective Action (PCA) framework. The proposed PCA framework includes new ratios corresponding to the various capitalization designations contained in PCA. Notably, the proposal does not factor the capital conservation buffer in the PCA ratios.

In our view, under the current proposal, institutions will have to manage their capital levels with too many consequential measures in mind. The proposals include new minimum capital requirements, new additional capital requirements for capital conservation buffer purposes, and new PCA requirements. The Agencies should work to streamline the PCA requirements to acknowledge the presence of the capital conservation buffer and clarify the implications associated with the various thresholds. We should work to minimize the operational complexity at institutions that can arise from numerous regulatory capital measures.

The currently proposed framework presents an awkward situation for institutions. For instance, the proposed measure of total risk-based capital to be considered "well-capitalized" for PCA purposes is 10%, yet the minimum total risk-based capital ratio including the 2.5% capital conservation buffer is 10.5%. Therefore, institutions may be "well-capitalized" but still have mandatory restrictions on dividend and bonus payouts. We encourage the Agencies to acknowledge and resolve such discrepancies that may result in confusion for bank management.

UNREALIZED GAINS AND LOSSES ON SECURITIES IN COMMON EQUITY TIER 1 CAPITAL

Under the Agencies' current general risk-based capital rules, unrealized gains and losses on Available For Sale (AFS) debt securities are not included in regulatory capital, unrealized losses on AFS equity securities are include in tier 1 capital, and unrealized gains on AFS equity securities are partially included in tier 2 capital. Under the proposal, unrealized gains and losses on all AFS securities would flow through to common equity tier 1 capital.

CSBS does not believe this provision is workable or meaningful for banking organizations. Including gains and losses on AFS securities in the common equity ratio would introduce significant volatility in capital ratios and potentially skew institutions' capital positions both in times of crisis and in periods of stability. The frequency and extent to which the proposed provision would adjust capital positions would be substantial. We believe capital measurements that are built on potentially significant volatility are not meaningful and may have detrimental consequences for the safety and soundness of our banking industry. We are concerned that this provision may cause banks to engage in transactions that they otherwise would not out of fear of the impact of potential future losses from changing market conditions. Incorporating this element of volatility into the capital framework is not in the long-term best interest of individual banks or the banking system.

The proposal offers possible alternatives, including excluding the impact solely from changes in interest rates and excluding U.S. government and agency securities. Firms that provide investment advisory services to the industry believe this will be nearly impossible to accurately quantify on a consistent basis. The Agencies should adequately research this perspective before finalizing any rule to ensure the option is workable and meaningful. To be clear, we believe the existing framework is more applicable to a traditional bank and provides for less complexity and greater stability.

Trust Preferred Securities

Basel III eliminates Trust Preferred Securities (TPS) as qualifying capital for all banks and bank holding companies above $500 million in assets. For bank holding companies with assets above $15 billion, the Basel III proposal maintains consistency with Dodd-Frank, retaining a phase-out period ending in 2016. For bank holding companies with assets between $500 million and $15 billion, the Agencies have proposed a phase-out schedule beginning at 10% in 2013 and increasing 10% a year for 10 years. No TPS would count beginning in 2022. The proposed treatment of TPS deviates from Dodd-Frank, which allows bank holding companies between $500 million and $15 billion to let the TPS roll-off.

CSBS strongly opposes the Agencies' proposed treatment of TPS for institutions between $500 million and $15 billion. The proposed rule represents a new and unnecessary extreme in the area of TPS. We are troubled by the Agencies' inclination to deviate from the Dodd-Frank standard. Implementing a sudden shift in policy related to TPS may have significantly negative consequences for institutions' capital planning strategies. Further, CSBS believes this matter was thoroughly reviewed in Congress during Dodd-Frank deliberations, and Congress elected to establish the framework detailed above for good reason. We therefore urge the Agencies to withdraw their proposed phase-out of TPS for institutions between $500 million and $15 billion and maintain the framework established by Congress.

Capital Transition Provisions and Information Gaps

CSBS generally believes the Agencies have proposed reasonable transition provisions for institutional compliance with the proposed capital requirements if the requirements are imposed.

We would also like to note that a number of information gaps exist in current financial reporting requirements that will make it difficult to assess the potential impact of various provisions of the proposal. Specifically, financial positions such as Deferred Tax Assets (DTAs) are not reflected in current regulatory reports in adequate detail, yet there are a number of proposed provisions affecting these assets. In order to adequately measure the impact of such requirements, we need to address reporting gaps in these areas.

CONCLUSION

We are supportive of the Agencies' efforts to improve the level and quality of minimum required capital. We strongly recommend the Agencies pursue a more simplistic and effective proposal appropriate for a diverse banking system which is largely dominated by less complex, community based institutions.

As the Agencies consider a revised and narrower proposal, it is important to be able to quantify the impact on the industry. We appreciate the Agencies' efforts to develop the capital estimation tool for banks to analyze the potential impact of this rule and the proposed rule for the Standardized Approach. We believe it is imperative for the Agencies to understand the impact on an aggregate basis and, more importantly, have a better sense of how changes in the capital rules will impact the bank's origination of credit.

Best regards,

John W. Ryan
President & CEO