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-AD96

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington DC, 20219
Docket ID OCC-2012-0009

Jennifer J. Johnson
Secretary, Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R-1442;
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 adjust the Agencies' general risk-based capital requirements for determining risk-weighted assets, entitled *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements.*

CSBS supports the Agencies' efforts to improve capital standards for the US banking system. We hope the Agencies will work to establish standards that are in the best interest of all financial institutions and the larger US economy. We have provided feedback on the Agencies' Basel III proposed rule in a separate comment letter. Our comments on the Standardized Approach proposed rule are organized in the sections below.

SUMMARY OF CSBS POSITION

CSBS is opposed to the proposed rule to revise the risk weights for risk-based capital. We come to this very clear position after extensive study of the proposal and dialogue with state supervisors. This position is based on the following concerns and beliefs:

1. The proposed rule is reactionary to the most recent crisis with a focus on housing and commercial real estate.

2. The approach proposed by the Agencies will curtail bank lending in traditional mortgage products that they have generally managed well.
3. There is no empirical support for the proposed risk weights.
4. As we seek to address concerns that emerged from the financial crisis, greater appreciation must be paid to risk management and the supervisory process to address evolving risk concentrations rather than capital weightings of broad asset types based solely on imperfect correlations perceived from the last crisis.
5. The proposed framework is overly complex.
6. There is not sufficient understanding of the impact of the proposed rule on the industry, the potential change in business practices, and the impact on credit availability.

The approach taken by the Agencies is targeted at the major risk drivers for problem banks during this crisis. However, while over 450 institutions failed from 2008 through the present, we must remember that the majority of institutions did not fail. In fact, out of the nearly 2,300 banks with concentrations in commercial real estate loans in 2007, over 1,200 maintained a low level of problem assets and are profitable today.

As we seek to improve the quality and quantity of capital, we believe it is important to resist the temptation to address every financial weakness through capital. We must seek to apply lessons learned to improving risk management and the supervision process. If not, we will continuously seek to make the industry more risk averse, which will curtail access to credit and harm economic growth.

CSBS has supported prior agency efforts to enhance the risk sensitivity of the capital rules. We commented in January 2006:

> "a successful domestic capital framework will not only benefit individual financial institutions which effectively utilize risk management tools, but will also benefit the banking system as a whole by providing greater ability to effectively and efficiently manage capital."

The challenge before the Agencies is to do this while not adding complexity. We do not believe the rule as proposed meets these objectives. The proposed rule is not balanced in its treatment of exposures and will present undue complexity for the industry. Unfortunately, we must recognize that risk-based capital has limited utility for bank management. Bankers have clearly communicated to state commissioners that they view this as a regulatory exercise, not a tool for risk management. We must question the value of a proposed regulation which provides little or no value to the industry. As state and federal supervisors find value in the framework, we believe it would be worthwhile to enhance our collective understanding on a framework which would prove valuable for the industry and the regulators.

In order to truly improve the risk sensitivity of the capital rules, the categorization of exposures and risk weights need to be supported. The categorization of assets should be aligned with the variety of practices of banks for the origination of credit, while accepting that banks have different levels and areas of expertise and appetite for risk. The assigned risk weights must have a reasonable correlation with the risk and not be used as a tool for the allocation of credit and the creation of an overall more conservative industry.

In the implementation of Basel II, the Agencies went through a series of "Quantitative Impact Studies." This was important to understand the impact on banks and the ability to conform to the framework. From this, public policy makers and observers were able to judge and opine on the readiness of institutions, the impact on the banks, and the potential changes to the credit markets and availability. While a comprehensive impact study would create its own burdens, the system and the economy are ill-served by not having a better understanding of the desirable and undesirable ramifications of changing the risk weights in the manner proposed. Based on industry reactions, the proposal will clearly have a negative impact on credit allocation. Policy makers have a responsibility to understand these changes and evaluate the potential impact on the banking system and economy.

RESIDENTIAL MORTGAGE EXPOSURES

Current risk-based capital requirements generally prescribe a 50% risk-weighting for residential mortgage exposures. The proposed rule introduces a complex scheme for risk-weighting residential mortgage exposures. This process divides residential mortgage exposures into two categories: Category 1 and Category 2. The Agencies have proposed a detailed set of standards that mortgages must meet in order to achieve Category 1 status. Among other criteria, Category 1 mortgages must be fully amortizing, without a balloon payment, and meet strict underwriting criteria. Any mortgage that does not meet the Category 1 criteria would be deemed a Category 2 mortgage.

Once a mortgage is categorized, its risk-weighting would be assigned based on the Loan-to-Value (LTV) ratio of the loan within the eligible risk-weighting range of the category. Category 1 mortgages would be assigned a risk-weighting between 35% and 100% based on LTV. Category 2 mortgages would be assigned a risk-weighting between 100% and 200% based on LTV.

CSBS believes the proposed treatment of residential mortgage exposures will have a detrimental effect on access to mortgage credit. We strongly oppose the proposed scheme for risk-weighting residential mortgage exposures, and we urge the Agencies to re-work or abandon the proposed approach. Chief among our concerns is the excessively narrow criteria for Category 1 mortgages. In our estimation, traditional products such as adjustable-rate mortgages (ARMs) and other products with balloon features would not qualify as Category 1, subjecting them to the Category 2 risk weights. Many banks also offer second lien and Home Equity Lines of Credit (HELOCs). This is an important source of credit for consumers and small businesses. These loans would also be designated as Category 2. The highly punitive risk-weightings for all mortgages in Category 2 would effectively discourage institutions from engaging in such transactions. Thus, designation of these transactions as Category 2 loans will largely eliminate an important source of credit for consumers and small businesses and a reliable business line for the institutions, thereby restricting access to credit and negatively impacting the safety and soundness of banking institutions, and the overall economy.

We are concerned that the rule unnecessarily paints these products with a very broad brush. This could have an impact on the availability of certain loan products. There were certainly problems with some adjustable rate and balloon products in the financial crisis. However, these problems should be addressed in a manner that does not inhibit traditional products that banks have managed successfully and that have benefited consumers. The legitimate concerns generated from the poor underwriting and risk management practices of a few institutions should not be addressed through a capital rule applicable to the entire industry. If the proposal is adopted in its current form, the banking industry will enter a counterintuitive phase whereby unsecured loans, which receive a 100% risk-weighting under the proposal, will effectively be deemed safer than many loans secured by collateral, a concept that contradicts the basic principles of banking. Furthermore, the proposed risk-weighting framework will push more residential mortgage business into lines that receive government support, as most government sponsored mortgage programs receive a low risk-weighting under the proposal.

It is critical to acknowledge that while the residential mortgage industry is vast, and a large portion of mortgage activity takes place off banks' books, the volume of residential mortgage exposure held in portfolio at banking organizations is not at all insignificant. Indeed, the commercial banking industry holds over $2 trillion in residential mortgage exposure in portfolio. Notably, residential mortgage exposures comprise an average of 17% of a bank's assets. While the securitization market has become the dominant source of mortgage funding, the assumption that this is not an important exposure for banks is incorrect. A bank's ability to originate and hold residential mortgage product is an important part of its asset mix and allows for a customization of credit beneficial for the consumer. Public policy should not inhibit this activity.

In a period where a coherent plan for addressing broader housing finance reform has not emerged, we believe this proposal, which would limit residential mortgage activity at institutions that are willing to take on the risk associated with this important class of credit, is ill-advised.

HIGH VOLATILITY COMMERCIAL REAL ESTATE (HVCRE)

Current risk-based capital requirements prescribe a 100% risk-weighting for acquisition, development, and construction (ADC) loans. The Agencies have proposed a new risk-weighting for High Volatility Commercial Real Estate (HVCRE) loans. An HVCRE loan would be defined as a credit facility that finances or has financed the acquisition, development, or construction of real property, unless the facility finances one-to four-family residential properties or commercial real estate projects that demonstrate certain LTV or borrower contribution standards. HVCRE loans would receive a 150% risk weighting under the proposal.

The impact of the proposed treatment of HVCRE loans could have negative unintended consequences for banks and the broader economy. The proposed approach, with a highly punitive risk weight, fails to adequately account for an institution's experience and expertise in this type of lending, the adequacy of its policies and procedures, and the level of concentration. Issues with development and construction lending should be addressed at the risk management level and through the supervisory process. The proposed 150% risk weighting is effectively telling institutions not to engage in this type of lending.

Strikingly, under the proposed rule, sovereign debt that is in default receives the same risk-weighting treatment as the construction and development loans detailed above. Other sovereign debt in substantially struggling countries that are not in default receives a potentially more attractive risk-weighting than HVCRE loans. Considering these relative risk-weightings, the Agencies are effectively signaling to banking organizations that investing in struggling countries such as Greece is as sound as investing in real estate projects in their local communities. This implied direction will cause many banking institutions, particularly community banks, to re-evaluate their asset mix to the detriment of community focused business lending.

We recognize construction and development lending has posed significant risks for many community banks over the past few years. However, as discussed above, to the extent a construction and development loan poses safety and soundness issues for an institution, those issues should be addressed through the supervisory process. The Agencies should not feel compelled to penalize broad types of transactions through capital rules rather than addressing the concentrations that were problematic during the last crisis. Further, it is important to note that while many community banks struggled in their risk assessment of construction and development loans, many more were successful and prudent in construction and development lending. The successful banks frequently established loan concentration limits that forced them to engage in prudent risk selection which recognized the distinct differences within broad loan types. CSBS therefore urges the Agencies to re-contemplate the proposed framework for HVCRE loans.

PAST DUE EXPOSURES

Under current general risk-based capital rules, the risk weighting of an exposure does not change if it becomes past due, with the exception of residential mortgage loans. In the NPR, the Agencies have proposed to require banking organizations to assign a risk-weight of 150% to an exposure that is not guaranteed or not secured if it is 90 days or more past due or on nonaccrual.

This provision will introduce more volatility and potentially sudden shocks into the capital planning process. Additionally, we note that levels of past due exposures may change frequently from quarter to quarter. We should strive to establish provisions that will not cause frequent fluctuations in risk-weighted assets on a quarterly basis.

CSBS would also like to point out that increasing the risk-weighting for past due loans involves some measure of "double-counting." When an exposure becomes past due, there are generally allowance provisions that require institutions to reserve capital for those exposures in case they default, effectively lowering institutions' capital levels. Therefore, increasing the risk-weighting for past due loans will effectively adjust both the numerator and denominator in risk-based capital ratios, compounding the negative effect on the ratio.

Finally, it is important to note that there exist classes of past due loans that are designated as such for administrative reasons. For example, exposures may be past due while institutions are waiting on financial statements, appraisals, or other pertinent financial information. In these cases, institutions will refrain from renewing the loan until the technical issues are resolved. We do not believe institutions should have to hold additional capital against these types of past due exposures.

Off-Balance Sheet Exposures

Within the context of off-balance sheet exposures, the NPR states that if a banking organization provides a credit enhancing representation or warranty on assets it sold or otherwise transferred to third parties, including in cases of early default clauses or premium-refund clauses, the banking organization would treat such an arrangement as an off-balance sheet guarantee and apply a 100% credit conversion factor to the exposure amount. While it appears that standard representations and warranties for fraud, misrepresentation, & documentation deficiencies that have traditionally accompanied secondary market sales of mortgages to investors would be exempted from the risk-based capital requirements, we request the Agencies explicitly clarify whether these traditional representations and warranties are indeed exempt. We believe that requiring institutions to hold capital against these representations and warranties will have detrimental consequences for mortgage banking.

Securitizations

Dodd-Frank requires financial regulators to strip references to credit ratings from their regulations. This clearly has an implication for securitizations, as the risk-weighting framework in this area has traditionally referenced credit ratings. Under the proposal, a banking organization would generally calculate a risk-weighted asset amount for a securitization exposure by applying either: (1) the simplified supervisory formula approach (SSFA), or (2) for banking organizations not subject to the market risk rule, a gross-up approach similar to an approach provided under the general risk-based capital rules. Alternatively, a banking organization may choose to apply a 1,250% risk weight to any of its securitization exposures.

We acknowledge that the Agencies are required to adjust their regulations in this area to account for the Dodd-Frank mandate. We would like to note that the proposed approaches for measurement and due diligence requirements, which generally require complex methods of evaluating the underlying collateral in securitizations, may be difficult for community banks to administer, and the alternative proposed risk-weighting is punitive. CSBS encourages the Agencies to explore a simpler method for applying these standards to community banks. We are concerned the proposed approach will significantly impair an institution’s ability to manage its balance sheet through the economic cycle. We believe that in order to have a vibrant and diverse banking system, banks of all sizes need the ability to manage the balance sheet with a variety of exposures.

Equity Exposures

Under the proposal, a banking organization would determine the risk-weighted asset amount for each equity exposure by multiplying the adjusted carrying value of the equity exposure by the applicable risk weight set out in the Agencies' proposed Simple Risk-weight Approach Table for equity exposures. The proposal also permits banking organizations to apply a 100% risk weighting to certain equity exposures deemed non-significant.

The Simple Risk-weight Approach Table is straightforward. However, we believe the scope of the 400% equity exposure category applied to non-publicly traded entities should be clarified. We would be particularly concerned if this risk-weighting is assigned to equity exposures such as stock ownership in bankers' banks. It seems that stock ownership in bankers' banks might qualify as a non-significant equity exposure if the ownership meets certain characteristics, thereby achieving a lower risk-weighting. Nevertheless, the industry would benefit from clarity in this area. The Agencies also inquire as to whether they should explore an alternative proposal to simplify the risk-based capital treatment of banking organizations' non-significant equity exposures. We support such an effort.

OTC DERIVATIVES

CSBS requests clarity on what is meant by "netting" within the context of OTC Derivatives in the proposed rule. Netting occurs in many forms. If the proposed rule is simply referring to netting within the context of various master netting agreements, we would like to note that the definition of netting within those agreements can vary widely. To the extent institutions comply with this provision, the Agencies should be aware of the variety of netting arrangements that exist under the master agreements.

MARKET DISCIPLINE AND DISCLOSURE REQUIREMENTS

The Basel Committee on Banking Supervision (BCBS) introduced additional capital disclosure requirements in its 2011 paper entitled, "Definition of Capital Disclosure Requirements." The Agencies are proposing to apply these disclosure requirements to banking organizations with assets greater than $50 billion. CSBS endorses the Agencies' proposed disclosure requirements for large institutions. However, it is important to ensure that these requirements will not flow down to community banks in the future. We generally do not believe that the specific disclosure requirements would be necessary for smaller banks or beneficial to community bank stakeholders.

REGULATORY FLEXIBILITY ACT ANALYSIS

The Regulatory Flexibility Act (RFA), 5 U.S.C. 601 requires an agency to provide an initial regulatory flexibility analysis with a proposed rule or to certify that the rule will not have a significant economic impact on a substantial number of small entities (defined for purposes of the RFA to include banking entities with assets less than or equal to $175 million).

We are troubled by the inconsistent and, in our view, inadequate approach the Agencies took in addressing this requirement. The FDIC and the OCC certify in their analyses that the Basel III and Standardized Approach NPRs, taken together, "appear to have a significant economic impact on a substantial number of small entities." The Federal Reserve's analysis is less conclusive.

Conclusion

The proposed rule provides an important opportunity for the industry and policy makers to debate how various rules should apply to a variety of institutions. The Agencies deserve credit for the extensive outreach they have conducted to ensure the industry understands the proposal. This process should yield the Agencies valuable information on the potential impact that this proposed rule will have on banking operations, access to credit and the broader economy. We believe this is an important opportunity for the Agencies to consider what is realistic and practical for a variety of institutions, appreciating the diversity of the system.

We believe it is important for the capital rules to take a long-term view of the industry and exposures. In this regard, broad risk weights have served regulators reasonably well, with specific information about risk exposures supplemented by supervision. While it can be tempting to attempt to fine tune the risk identification, there is a fine line between enhanced risk sensitivity and credit allocation.

Most importantly, we believe it is imperative to understand the potential impact not only on capital in the banks but also on their behavior in originating credit. An overly conservative industry will not be in the position to serve consumers or local economies. We appreciate that the Agencies must do certain things to comply with the Basel III international accord and the Dodd-Frank Act. The Agencies should pursue a rulemaking with the absolute minimum changes required to comply with the law. We strongly encourage the Agencies to undertake a larger study to evaluate long-term capital standards under a framework which meets the needs of regulators and is consistent with the variety of business models of our banking industry.

Best regards,

John W. Ryan
President & CEO