INDEPENDENT COMMUNITY BANKERS of AMERICA®

October 22, 2012

Mr. Ben Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Thomas J. Curry
Comptroller
Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

Mr. Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action--OCC Docket ID OCC-2012-0008, Federal Reserve Docket No. R-1430; RIN No. 7100-AD87, FDIC RIN 3064-AD95

Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements—OCC Docket ID OCC-2012-0009, Federal Reserve Docket No. R-1442; RIN No. 7100 AD87, FDIC RIN 3064-AD96

Dear Sirs:

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to provide comments on the joint proposed rulemakings titled *Regulatory Capital Rules:*

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[1] The Independent Community Bankers of America®, the nation's voice for more than 7,000 community banks of all sizes and charter types, is dedicated exclusively to representing the interests of the community banking industry and its membership through effective advocacy, best-in-class education and high-quality products and services.

With nearly 5,000 members, representing more than 23,000 locations nationwide and employing more than 280,000 Americans, ICBA members hold more than $1.2 trillion in assets, $1 trillion in deposits, and $700 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action and *Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*. The application of these two proposals to community bank regulatory capital represent a very large shift in the definition of regulatory capital, minimum capital requirements, and risk sensitivities of certain financial institution assets that will heavily impact all community banks in the United States in an overwhelmingly negative manner and will inflict irreversible damage on these institutions and the communities they serve. In short, the proposals will significantly erode community bank profitability and credit availability, and drive industry consolidation. Many community banks will be unable to survive these rules as they are currently proposed and will be forced to merge or consolidate with other institutions.

ICBA supports strong minimum capital levels for all banks, including community banks. However, many of the provisions in the proposed rules are advanced without due consideration of their impact on community banks and their ability to continue to serve the needs of their customers in the thousands of communities they serve across the nation. The introduction of the capital conservation buffer, new definitions for common equity tier 1 regulatory capital, new risk weightings for certain assets including residential mortgages, and the timeline proposed for adoption of the new minimum capital levels, present many expensive, complex, and unnecessary regulatory burdens for community banks that contribute little or nothing toward improving the strength and stability of the nation's community banks.

ICBA urges the regulators to make widespread modifications to both proposals and wholesale exemptions, where necessary, when applying them to community banks to better reflect the inherent risks in the community banking business model without jeopardizing the current strong capital position that community banks have continually maintained for many years even through the recent financial crisis. Let us remember that community banks were not the cause of the financial crisis of 2008. Their simplified balance sheets, conservative lending practices, and common sense underwriting shielded their regulatory capital balances from the losses that heavily impacted the large, complex, internationally-active and interconnected worldwide financial institutions. Furthermore, Basel III was conceived as a standard that would apply only to the largest, internationally active banks so that, for instance, a large European bank would be subject to the same capital standards as its large banking competitor in the United States. It was never intended to apply to a domestic community bank.

Summary of ICBA Comments

ICBA supports strong capital requirements. However, Basel III and the standardized approach are regulatory overkill for community banks and go much further than is necessary to make capital standards more robust for all banks. **ICBA strongly believes that 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 and that are not subject to enhanced prudential standards under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") because they**

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are not deemed to be systemically important financial institutions or SIFIs. These banks should not be subject to the complex risk weights and capital requirements of Basel III and the standardized approach.

However, 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:

- ICBA strongly recommends that the regulators fully exempt banks under $50 billion in assets from the standardized approach for risk weighted assets. The new, drastic, complex, and punitive alteration of risk weighting for residential mortgages could single-handedly wipe out community banks that depend on residential lending to serve the needs of their communities;
- absent supporting evidence showing that they are risky assets, the proposed substantially higher risk weights for balloon mortgages and second mortgages should be reduced to their current Basel I levels to better reflect 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;
- alternatively, 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 those bank holding companies with consolidated assets between $500 million and $15 billion to reflect Congressional intent and reduce the capital burden for those community banks that would have difficulty raising capital;
- as was proposed 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;
- bank regulators should include the allowance for loan and lease losses (ALLL) as part of the definition of tier 1 capital in an amount up to 1.25% of risk weighted assets while 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;
- bank regulators should continue to allow mortgage servicing assets to be subject to the same higher deduction thresholds that apply under current rules as they do not pose a risk to community bank capital;
- community banks and in particular, Subchapter S banks should be exempt from the provisions of the capital conservation buffer. Alternatively, the phase-in period for the capital conservation buffer should be extended by at least three 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 need to be substantially simplified and amended so that community banks will not be discouraged from investing in other financial institutions, particularly 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 risk weights under the standardized approach should be applied prospectively to give community banks enough time to comply;
- regulators should make accommodations to ensure that 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; and
- 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.

ICBA notes that it is not alone in recommending substantial changes to the proposed Basel III and standardized approach. In addition to banks of all sizes, many impacted stakeholders like state regulators and members of Congress have also expressed their opposition to the proposals. The Conference of State Bank Supervisors (CSBS), in a statement[2] on the proposals, expressed concerns with the standardized approach with particular focus on the risk weights for residential mortgages and high volatility commercial real estate. CSBS supports a less complex capital framework that promotes a strong banking system and a strong economy. Additionally, members of Congress in both the House of Representatives and Senate have voiced their concerns on the potential harmful impact of Basel III and the standardized approach on their constituents and their communities.

Background

The proposed rulemakings represent the adoption in the United States of the regulatory capital framework[3] created by the Basel Committee on Banking Supervision in Basel, Switzerland. The purpose of the undertaking of the Basel Committee was to strengthen the regulatory capital framework for internationally active and interconnected banks by raising both the quality and quantity of their regulatory capital. This effort was executed in response to the global economic and financial crisis of the last five years where the solvency and liquidity of internationally-active banks has been in question and in some cases in jeopardy. The response to the Basel Committee's call for regulatory capital changes for internationally active banks in the United States was proposed by the three banking regulators on June 7, 2012 and was issued for public comment as three separate notices of proposed rulemaking. ICBA is providing comment on two of the three releases. The third document, which discusses the advanced approaches, is not applicable to community banks and applies only to the largest financial institutions.

[2] Conference of State Bank Supervisors, *Statement on Federal Banking Agencies' Proposed Capital Rules*, dated October 3, 2012
[3] See the document titled *Basel III: A global regulatory framework for more resilient banks and banking systems* issued December, 2010 (rev June, 2011)

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Regulatory Capital

The first document, which covers the definition and calculation of minimum regulatory capital, covers three capital measurements starting with common equity tier 1 capital. The proposal would apply to banking organizations of all sizes that are currently subject to minimum capital requirements, all top-tier savings and loan holding companies, and all top-tier bank holding companies with total consolidated assets of $500 hundred million or more. Regardless of whether a bank holding company meets the minimum asset requirement to implement the proposal, all banks consolidated by the holding company would be subject to the proposal regardless of size.

This proposal introduces a new capital measure known as common equity tier 1 capital, which is composed of an institution's most basic residual equity and includes common stock, additional paid-in-capital, retained earnings, AOCI, and, if applicable, a component of the institution's minority interest. Additional tier 1 capital would include certain equity instruments that do not qualify for inclusion in common equity tier 1 capital such as non-cumulative perpetual preferred stock and certain minority interests. Trust preferred securities and cumulative perpetual preferred securities, equity instruments that currently qualify for inclusion in tier 1 capital today, would be excluded from this measure under the proposal. Tier 2 capital includes the component of the allowance for loan and lease losses (ALLL) that does not exceed 1.25% of total risk-weighted assets. Cumulative perpetual preferred stock and trust preferred securities, which would not qualify for inclusion in additional tier 1 capital, may qualify for inclusion here if certain criteria are met.

All banks would be required to maintain a minimum ratio of common equity tier 1 capital to total risk-weighted assets of 4.5%, a ratio of tier 1 capital, which is defined as the sum of common equity tier 1 capital and additional tier 1 capital, to total risk-weighted assets of 6.0%, and a ratio of total capital, which is defined as the sum of common equity tier 1 capital, additional tier 1 capital, and tier 2 capital, to total risk-weighted assets of 8.0%. Additionally, all banks would be subject to a minimum tier 1 leverage ratio of 4.0%. This ratio would be calculated by dividing tier 1 capital by average total consolidated assets, net of regulatory capital deductions for tier 1 capital. In addition to the minimum regulatory capital levels, banks would be subject to an additional 2.5% capital conservation buffer on common equity tier 1 capital, tier 1 capital, and total capital that must be met solely with common equity tier 1 capital. In the event that a bank does not meet the capital conservation buffer for any one of the three regulatory capital measures, the bank would be subject to limitations on the ability to make capital distributions, discretionary bonus payments to the bank's executive officers, and repurchase capital stock.

The new minimum regulatory capital requirements for common equity tier 1 capital, tier 1 capital, and total capital become fully effective on January 1, 2015 and are preceded by a phase-in period that starts on January 1, 2013. The capital conservation buffer becomes fully effective on January 1, 2019 with a phase-in period that starts on January 1, 2016. The regulatory capital deductions that are currently made from tier 1 capital would be required to be deducted from common equity tier 1 capital starting in 2014 with a phase-in period that ends in 2018. The inclusion of AOCI in common equity tier 1 capital would follow a phase-in period from 2014 to 2018. For all banks and bank holding companies under $15 billion in assets, non-qualifying capital instruments would be phased out starting in 2013 with a full exclusion by 2022.

Standardized Approach

The second document, known as the standardized approach, covers the new risk weightings for assets used to determine a bank's risk-based regulatory capital ratios. Similar to the proposal on minimum regulatory capital, this proposal would apply to all banks, all top-tier savings and loan holding companies, and all top-tier bank holding companies with total consolidated assets of $500 hundred million or more. Regardless of whether a bank holding company meets the minimum asset requirement to implement the proposal, all banks consolidated by the holding company would be subject to the proposal regardless of size.

Exposures to the U.S. government or to a U.S. government agency will continue to receive a zero percent risk weight if they are directly and unconditionally guaranteed by the U.S. government. Exposures to government-sponsored enterprises that are not equity investments would remain at 20 percent risk weight with equity exposures continuing to carry a 100 percent risk weight. General obligations of states, municipalities, and local authorities would remain at 20 percent risk weight unless the obligations are revenue obligations for specific projects, where they carry a 50 percent risk weight. Most residential mortgage exposures would be divided into two categories based on the characteristics of the mortgage. Category 1 residential mortgages are first lien mortgages with the following characteristics: a term that does not exceed 30 years, regular payments with no increase in the principal balance, and no ability to defer repayments of principal or terminate the loan before full amortization with a balloon payment. All other residential mortgage exposures would be category 2 residential mortgages.

The risk weightings for each category of residential mortgage would be further determined by the loan-to-value ratio of the loan at origination and would range from 35 percent risk weight to 200 percent risk weight. Certain commercial real estate mortgages that present elevated risks will be assigned a risk weight of 150 percent. Loans that are 90 days or more past due or are on non-accrual status will carry a risk weight of 150 percent unless the loan is a residential mortgage loan. Residential mortgage loans that are 90 days or more past due or are on non-accrual status will follow the category 2 risk weighting matrix for residential mortgage loans discussed above. New additional capital requirements are added for off-balance sheet exposures, securitizations not issued by a government agency or a government service enterprise, and investments in equities.

ICBA's Comments

General Comments. The proposed Basel III regulatory capital framework and standardized approach will do a great deal of harm to all community banks and could single-handedly eliminate community banking in many rural and underserved areas. Because larger banks will not conduct business in these areas, whole sections of the

United States could effectively become "unbanked" with the implementation of these proposed rulemakings. Many community banks will be forced to merge, consolidate, or significantly curtail lending to improve their capital positions or to comply with the additional regulatory burden. The end result is slow or non-existent economic growth, higher unemployment, and a highly concentrated banking system with increased systemic risk.

In introducing the Basel III and standardized approach proposals, regulators stated that most community banks will be able to meet the new minimum capital requirements and continue to be well capitalized. However, it is unclear at this point whether the regulators have actual data to support this claim. For example, much uncertainty arises when trying to assess the impact of including the balance of AOCI in regulatory capital because the primary drivers of changes to AOCI, benchmark interest rates and credit spreads, can vary widely in various economic environments even among different regions of the country. Without data on the loan-to-value ratios of mortgages held in community bank portfolios, the impact of the changes in risk weights to residential mortgages cannot be determined. ICBA recommends that the regulators conduct a thorough analysis of the impact of Basel III and the standardized approach on community bank capital, including outreach to individual community banks. From our discussions with community bankers, we believe that this analysis would show that the impact on community banks across the nation would be substantial.

For many community banks with regulatory capital ratios that are substantially above the well-capitalized level today, the Basel III and standardized approach proposals will reduce regulatory capital levels such that these institutions may now only be barely above the well capitalized threshold or adequately capitalized at best. This eroded community bank capital is crucial to demonstrating that these banks conduct their operations from a position of capital strength. With these reduced capital levels, community banks will lend less and local economies will suffer as a result. Additionally, the regulators have not provided explanation for why the current definitions of regulatory capital and the risk weights for assets as they are applied to community banks is problematic. ICBA recommends that the regulators address this concern to better understand if changes are needed for community bank regulatory capital.

Changes to Regulatory Capital Introduce Harmful Volatility in Capital Adequacy.
ICBA supports strong capital requirements for all financial institutions including the smallest community banks and the largest internationally active money center banks. Our experiences in the recent financial crisis remind us that banks need adequate levels of high-quality regulatory capital available to absorb both expected and unexpected losses at all times in the economic cycle. Stronger capital levels help to demonstrate a great deal of confidence in a bank's ability to weather any economic storm no matter how severe or prolonged. The minimum regulatory capital levels originally provided by the Basel Committee and further endorsed in the joint proposal must be strictly enforced for the largest banks to ensure that big bank bailouts are truly a thing of the past.

While the new regulatory capital minimum levels are instrumental in avoiding another financial crisis, the new definition of regulatory capital is quite concerning as it could easily start a capital crisis for all community banks**. The new measurement of common equity tier 1 capital, with its inclusion of AOCI, will introduce volatility in community bank capital measures that will require community banks to further increase capital balances.** Depending on the economic environment at any given time, additional capital cushions of two to three percent will be needed to ensure that a dramatic shift in asset fair values does not deplete current capital levels.

For most community banks, the balance of AOCI represents unrealized gains and losses on investment securities held available-for-sale. Securities held available-for-sale are carried at fair value with all unrealized gains and losses recorded in AOCI, which represents a component of shareholders' equity on the balance sheet. Most community banks do not electively choose to classify their securities portfolio as available-for-sale for financial accounting purposes. Community banks are forced to classify these securities at fair value as available-for-sale because current generally accepted accounting principles do not currently allow community banks to classify these securities at amortized cost without jeopardizing the liquidity of the bank. These securities are generally held solely for the collection of cash flows and held to their contractual maturity. They are not used for liquidity purposes. Because the objective of the community bank is to hold these securities for the long term, unrealized gains and losses attributable to periodic changes in interest rates and credit spreads is not relevant. These unrealized gains and losses do not provide any visibility into a community bank's ability to absorb credit loss, except in the most dire of circumstances.

AOCI is subject to a tremendous amount of volatility due to changes in interest rates, credit spreads, or any other sources of fair value change on the individual securities. The risk of increased volatility is especially problematic in today's ultra low interest rate environment where any meaningful increase in interest rates will require community banks to record losses in their balances of AOCI. These losses will be immediately and directly deducted from regulatory capital regardless of the source of the change in fair value. Additionally, the inclusion of the available-for-sale securities in regulatory capital represents only one component of the overall fair value risk faced by a community bank due to changes in interest rates. Loan assets, deposit liabilities, and other forms of financing liabilities are generally carried at amortized cost on the balance sheet**. So even though a bank has effectively eliminated its interest rate duration gap on an economic basis, changes in interest rates will adversely impact one specific asset type and disproportionately impact a bank's regulatory capital.**

ICBA's members share our concerns on the volatility of including AOCI in regulatory capital. Jack Hopkins, chief executive officer of CorTrust Bank in Sioux Falls, South Dakota, explains:

> *"At my bank, for example, if interest rates increased by only 300 basis points, which would still leave rates at or below historical averages, my bank's bond portfolio would show a paper loss of $22,750,000 versus a gain as of today of $7,450,000. This volatility of rates would reduce my capital by over 25%."*

Jeffrey Gerhart, chairman of the Bank of Newman Grove in Newman Grove, Nebraska, shares similar concerns:

> *"As of June 30, 2012 my available for sale portion of my bond portfolio had a gain of $274,880. If interest rates would increase by 300 basis points my bond portfolio will show a paper loss of $1,026,186. This will then have to be subtracted from my bank equity of $3,325,994 leaving me with capital of $2,299,808."*

Community banks are especially disadvantaged with the proposed inclusion of AOCI in regulatory capital when compared to other sizes of financial institutions. Larger banks can mitigate the volatility in AOCI caused by changes in interest rates by entering into qualifying fair value hedge accounting relationships by using one or more interest rate derivatives. This gives the larger banks a competitive advantage over community banks because they can more readily absorb the overhead necessary to engage in derivatives trading to manage interest rate risk. Community banks have limited ability to carry interest rate derivatives on their balance sheets due to the increased resources needed to maintain these risk mitigation activities. Because of this disadvantage, community banks are disproportionately impacted by the inclusion of AOCI in regulatory capital. The proposal, as currently written, does not address this key concern.

ICBA recommends that the bank regulators permanently exempt banks with total consolidated assets of $50 billion or less from including the balance of AOCI in common equity tier 1 capital, tier 1 capital, and total capital. If the regulators are unwilling to provide a full exemption for community banks, we strongly urge that certain investment securities that are deemed risk free or are essential to maintaining a healthy housing market be exempt. These securities would include all obligations of the U.S. government and mortgage-backed securities issued by Fannie Mae and Freddie Mac, as well as all municipal securities. For community banks, this would greatly simplify the process of computing AOCI and significantly reduce its volatility.

Phase out of TruPS As Tier I Capital is Inconsistent with the Collins Amendment. ICBA is extremely concerned about the proposed phase-out of trust preferred securities (TruPS) as a component of tier 1 capital. When the Dodd-Frank Act was being considered by Congress, ICBA played a leading role in shielding community banks from the impact of Section 171 of the act, known as the Collins Amendment. The Collins Amendment generally disallows the treatment of TruPS as tier 1 regulatory capital, but grandfathers tier 1 treatment of TruPS issued by bank holding companies prior to May 19, 2010 with total consolidated assets between $500 million and $15 billion. Mutual holding companies in existence as of May 19, 2010 and that issued TruPS prior to that date are also grandfathered.

The intent of the Collins Amendment was to permanently grandfather tier 1 capital treatment of TruPS issued by bank holding companies with consolidated assets of between $500 million and $15 billion and by mutual holding companies. It was not, as the banking regulators appear to believe, merely an exemption from the general requirements of the Collin Amendment that could be changed by regulation sometime in the future. Many community bank and mutual holding companies have based their long-term capital planning on the permanent grandfather provisions of the Collins Amendment. The proposed ten year phase-out of the tier 1 capital treatment of TruPS beginning in 2013 violates the clear intent of the Collins Amendment, which was to allow smaller bank holding companies to continue including the proceeds of these instruments as part of their core capital during the full term of these instruments, which is typically twenty-five to thirty years.

Furthermore, the phasing out of this important source of capital would be a particular burden for many privately-held community banks and bank holding companies that have greatly reduced alternatives for raising capital. Many trust preferred securities are floating rate and thus represent a cost effective source of capital in the current historically low rate environment. They could be refinanced only at significantly higher cost – if they could be refinanced at all.

According to Sandler O'Neill & Partners, dependence on trust preferred securities for consolidated tier 1 capital is heavily concentrated in issuers between $500 million and $10 billion in assets, with a total of 485 such institutions depending on trust preferred securities for 13.33% of tier 1 capital. Also, a significant number of institutions that issued TruPS also issued CPP and SBLF preferred stock with step-up coupons that will make the cost of their capital even higher. With compressing net interest margins and depressing asset yields continuing for at least two or more years, it is critical that community bank holding companies maintain this source of low-cost capital. Absent a compelling safety and soundness reason for accelerating the phase out of tier 1 treatment for community banks, which so far has not been demonstrated, the banking regulators should not change the current treatment of TruPS. **While we applaud the fact that TruPS issued by bank holding companies under $500 million would not be impacted by the proposal, consistent with the Collins Amendment we urge the bank regulators to continue the current tier 1 treatment of TruPS issued by bank holding companies with consolidated assets of between $500 million and $15 billion.**

Small Savings and Loan Holding Companies Need Basel III Exemption. Under the proposal, all savings and loan holding companies, regardless of size, are required to comply with Basel III. ICBA believes that the Federal Reserve has the authority to exempt small savings and loan holding companies from the proposal just as it has exempted small bank holding companies with assets of $500 million or less. Small thrift holding companies should not be forced to develop costly compliance programs to comply with Basel III. Many of these holding companies are shell thrift holding companies that would be adversely impacted by the proposal. There is no policy rationale to exclude small bank holding companies from the rule, but not exclude small savings and loan holding companies. **ICBA urges the Federal Reserve to exempt all bank and thrift holding companies with assets of $500 million or less from Basel III and the standardized approach.**

ALLL Should be Completely Included in Regulatory Capital. Another concern in implementing the new definition of regulatory capital involves the use of the ALLL in regulatory capital. Under the proposal, the treatment of the ALLL for regulatory capital remains unchanged. However, banks will be required to hold additional capital for seriously delinquent residential and commercial loans at levels significantly higher than they are required to today. Outside of external credit enhancements, the ALLL is the most immediate and relevant capital cushion available to absorb credit losses. Yet banks would be required to hold additional capital for those delinquent loans without giving any further recognition to the loan loss reserve also set aside for these loans.

ICBA believes there are compelling reasons for including some part of the ALLL as tier 1 capital. ALLL represents a reliable capital cushion available to a bank to absorb unanticipated credit losses. Furthermore, the banking regulators have never offered a satisfactory reason why there should be a percentage cap on the inclusion of ALLL as regulatory capital. **Therefore, for banks with total consolidated assets of $50 billion or less, ICBA recommends that the bank regulators allow the ALLL to be included in the definition of tier 1 capital at an amount up to 1.25% of risk weighted assets. Additionally, we urge the regulators to place the remaining balance of ALLL in tier 2 capital so that the entire ALLL will be included in a bank's total capital.** Alternatively, ICBA recommends that the regulators at a minimum remove the current cap on the ALLL for inclusion in tier 2 capital so that the entire ALLL can receive the proper capital recognition.

Including Mortgage Servicing Assets as Regulatory Capital Does Not Pose Risks to Community Banks. Under the proposal, mortgage servicing assets would be subject to complex threshold deductions when they exceed 10 percent of common equity tier 1 capital or exceed 15 percent of common equity tier 1 capital when combined with other instruments. This punitive treatment discourages community banks from obtaining and growing mortgage servicing portfolios. These portfolios act as safety nets for community bank earnings in times of rising interest rates and act as a natural hedge to falling economic values on other bank assets. More importantly, mortgage servicing assets allow loan customers to continue to bank locally with community banks, who will in turn provide a level of personal service that better serves borrower needs.

The only alternative for originators that sell loans will be to sell the loans servicing released and have a much larger loan servicer acquire the servicing rights. Because the larger loan servicers manage their businesses on a volume basis, the high-quality customer interaction of community bank loan servicers will disappear. **For banks with total consolidated assets of $50 billion or less, ICBA recommends that the bank regulators continue to allow mortgage servicing assets to be subject to the same higher deduction thresholds that apply under current rules.** If the regulators are unwilling to retain the current capital treatment for mortgage servicing assets, ICBA recommends that mortgage servicing assets be removed from the complex formula for threshold deductions and be evaluated independently with the threshold raised to a more common sense level above ten percent that does not penalize community banks for servicing mortgage loans in their respective communities.

Capital Conservation Buffers Are Harmful for Subchapter S Banks. Although ICBA is supportive of the strong minimum regulatory capital levels for common equity tier 1 capital, tier 1 capital, and total capital, we are concerned about the proposed implementation of the capital conservation buffer. It is unclear from the proposal whether the regulators have properly considered whether community banks will have enough time to absorb the heightened minimum regulatory capital requirements with the capital conservation buffer included. Aside from higher risk weights, new capital deductions, and the introduction of AOCI into the definition of regulatory capital, the ability to meet the aggressive phase-in period for the capital conservation buffer assumes that a community bank will maintain robust earnings from now until 2019 in order to build the capital necessary to meet the minimums. This assumption does not factor in a prolonged low interest rate environment or the possibility of a new economic recession that would prevent community banks from meeting the buffers. And, unlike large banks, community banks have no vehicle to quickly raise capital through the equity markets.

Many community banks have corporate structures that are driven by the tax treatment under the Internal Revenue Code. An estimated 2,300 community banks are incorporated as subchapter S corporations and are treated as pass-through entities for income tax purposes. The taxable income of the corporation flows through to the owners, who pay federal income taxes on an individual level. If the regulators prohibit these banks from making distributions to owners when the capital conservation buffer is not met, the owners themselves may be subject to income tax on earnings that cannot be paid. **ICBA is requesting that the bank regulators fully exempt banks with total consolidated assets of $50 billion or less from the provisions of the capital conservation buffer.** If the bank regulators are unwilling to make this accommodation, we urge that the phase-in period for the capital conservation buffer be extended by at least three years to January 1, 2022 to provide community banks with enough time to meet the new regulatory minimums. Regardless of the exemption or phase-in request, we believe that it is imperative that the regulators permanently exempt all community bank financial institutions from the capital conservation buffer to the extent that the buffer prohibits the distribution of taxable income to shareholders needed to pay federal income taxes on earnings if they are incorporated as a subchapter S corporation to avoid any conflict with the provisions of the current tax code.

The Standardized Approach Punishes Community Bank Residential Lending. The proposed standardized approach, with its drastic and punitive alteration of the risk weighting for residential mortgage loans, could single-handedly wipe out community banks that depend significantly on residential lending to serve the needs of the community. It is quite clear that the proposed rulemaking fails to take account of the high credit quality of mortgage loans made by community banks generally and of the unique nature of community bank home mortgage lending in rural areas of the United States. The standardized approach, with its eight different risk weightings for residential mortgages, is overly complex for application by community banks considering the low historical loss experience by community banks for their mortgage loans. The high-quality residential mortgage loans that community banks originate make the need for the complex risk weight scheme proposed under the standardized approach unnecessary.

The very narrow definition of a category 1 mortgage mistakenly omits balloon mortgages and second liens including home equity loans and lines of credit. Balloon loans that may amortize over a twenty or thirty year period generally result in a final maturity payment after five or seven years of the loan term. This popular loan product for both loan customers and community banks gives the customer the opportunity to match their appetite for extension risk. Additionally, balloon loans allow a community bank to properly manage the interest rate sensitivities of assets and liabilities without engaging in the use of complex and costly risk management processes and tools like interest rate derivatives.

Second liens like home equity loans and home equity lines of credit help to provide borrowers with the flexibility they need and are a major contributor to economic growth throughout the country. Although these loan products are often cited as an example of the past economic excesses of reckless homeowner leverage, prudently underwritten second liens serve a very important role in the prosperity of homeowners and the overall economy. These loan products are frequently used by homeowners to finance property improvements, send a child to college, and start a small business.

ICBA is concerned that the very narrow definition of what qualifies for a category 1 loan will force many community banks to abandon these products for their customers. Because community banks do not have the resources to tackle asset-liability management with traditional 30 year fixed mortgages, a great number of community banks will be forced to exit the residential loan business altogether. Community banks, their customers, their communities, and the housing economy will suffer as a result. Because the economic recovery is closely tied to the recovery in residential lending and construction, our fear is that the impact of these new risk weights could be another economic recession.

Community banks are especially concerned with the disadvantages the standardized approach would present to residential mortgages like balloon loans. ICBA and its members also note that the bank regulators have yet to present any evidence that balloon loans made by community banks have been problematic in the recent financial crisis. Milton Smith, president and chief executive officer of The First National Bank of Lawrence County at Walnut Ridge in Walnut Ridge, Arkansas, addresses the issue directly:

> *"Increasing the risk weights for residential balloon loans will penalize community banks who offer these loan products and deprive customers of financing options. All of my bank's portfolio loans are balloon notes. I believe my bank's loss rate is one of the best in the country. Balloon notes are not risky if they are managed correctly. We use balloon notes to mitigate interest rate risk. The customer chooses the note either because they want their loan to stay home or their property does not qualify for the secondary market. If this component of the proposal survives, my bank will drastically cut back on residential mortgage lending. Consumers in rural America will have more difficulties securing financing for a home."*

James Goetz, chairman and chief executive officer of Security First Bank of North Dakota in Mandan, North Dakota, adds more insight:

"Singling out residential mortgage balloon notes for harsher capital treatment makes no sense whatsoever. Nearly all community banks finance homes with balloon notes to manage interest rate risk, and they have done this successfully without any additional risk. Our bank has not experienced a loss on a residential balloon mortgage in the 44 years I have been at the bank. Further, there is no data that these types of mortgages in community banks have been more risky than any other type of home mortgage. In addition, these types of loans are often the only home loans available to community bank customers and this rule will cut those customers out of the housing market. For example, in many rural areas like the one we serve, customers cannot qualify for secondary market rules because there are few residential sales and therefore not enough comparable sales to meet secondary market appraisal requirements."

In addition to the harmful categorization for residential mortgages, ICBA is also concerned about the overreliance on origination loan-to-value ratio when determining the proper risk weighting for an individual loan. Prudent residential loan underwriting does not solely consider the loan-to-value ratio when assessing risk. Rather, the risk is assessed on a much broader picture of the borrower including borrower payment history, credit score, net worth, income, employment, and past customer relationships. The origination loan-to-value ratio, while a valuable indicator of risk, is merely one component of the overall risk profile of a loan.

Additionally, it is unclear how the regulators expect community banks to comply with the January 1, 2015 commencement date for the residential loan risk weighting framework under the proposal. The tools needed to source appraised value will be difficult for some community banks and will require those banks to invest a great deal in time, money, and resources to comply, including a manual review of every loan file. ICBA believes that the regulators need to better assess the availability of this data and the practicability of imposing this requirement when considering the impact of the standardized approach on community banks.

Further contributing to the harm to residential lending is the proposed elimination of private mortgage insurance as a credit enhancement in the standardized approach. ICBA believes that private mortgage insurance is an extremely valuable component of mortgage lending, especially for certain potential homeowners such as first time homebuyers who may not be able to make the considerable down payment required to purchase a home. ICBA recognizes that the recent drop in home prices has placed considerable strain on the mortgage insurance industry with concerns about some insurers' ability to make payments on claims. However, these concerns should not impact the ability to factor mortgage insurance coverage into the risk weights for residential mortgages for those mortgage insurance companies that can demonstrate the ability to make those claims. As long as the regulator of the mortgage insurance company concludes that the mortgage insurance company has the financial resources to fulfill a claim request, that company's mortgage insurance policies should represent a valid credit enhancement on a residential mortgage loan. The regulators should pay special attention not to further degrade the availability of mortgage financing to all potential homebuyers. Rather, they should work

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with the appropriate insurance regulators to develop a methodology for assessing the financial footing of these firms.

These higher proposed capital requirements for almost all residential mortgages, combined with other additional proposed mortgage regulations such as the "ability to repay" mortgages rules, the risk retention rules, and the rules on mortgage servicing, will burden community banks enough to make them exit the residential lending business altogether.

Imposing Higher Regulatory Capital for Past Due Loans Is Double Accounting. As discussed above, the new definition of regulatory capital fails to consider the fact that the allowance for loan and lease losses (ALLL) is the first line of defense in the bank's ability to absorb credit losses. Yet the proposal calls for higher levels of capital for past due and nonaccrual loans (i.e., past due commercial loans are risk weighted at 150%) including both residential and commercial loans. The end result of this flaw in the proposal is a direct deduction from capital for the allowance even though management of the allowance is a critical component of credit loss management. We suspect that this is a result of the direct conflicts exhibited by the Basel III and standardized approach proposals. Both proposals present two very different methodologies for elevating the impact of delinquent loans. When imposed together, they create a compounding headache for understanding the levels of capital readily available to absorb loss.

For stressed community banks, this increased capital requirement for past due loans has the potential to generate a spiral effect leading to even more bank failures. For example, a stressed community bank is told by its examiner that it must write off more of its loans. This requires the bank to not only increase its ALLL account but increase its capital since past due loans have increased. The resulting shock to the bank will stress the capital and earnings of the bank even more. If these new risk weights had been in effect during the recent financial crisis, more community banks would have failed. This particular interaction should be avoided so that any duplication of the impairment of a delinquent loan in a community bank's capital position is avoided.

Loan Securitization Treatment is Burdensome and Complex. An important concern with the proposed standardized approach involves securitizations of loans. ICBA understands that the Dodd-Frank Act mandate to remove external credit ratings requires the regulators to adopt a different approach to assessing risk within an individual securitization. However, the proposed gross-up approach for community banks is too complex to be implemented in a reasonable fashion. It also remains unclear whether the data needed to assign risk weights for the assets within the securitization will be available for consumption by the holder of the security. A proposed alternative approach, the default 1,250% risk weight, is not reasonable for all private label securitizations since it does not consider asset quality, credit enhancement, and priority of payments.

ICBA is very concerned that the approaches proposed for securitizations do not contemplate the future of the securitization market once the expected wind down of Fannie Mae and Freddie Mac is completed. If the private market is expected to step in and assume the securitization roles currently maintained by these two agencies, the

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regulators should be concerned that the burdens placed on holding securitization interests in the future may be cost prohibitive for many institutions contributing to a lack of demand. This lack of demand would have an extremely adverse impact on residential and commercial loan interest rates, including the most popular of commonly used loan products like traditional 30 year fixed rate mortgages.

New Off-Balance Sheet Exposures for Mortgages Sold Should be Removed. The standardized approach's proposed requirement to allocate capital to off-balance sheet items will be damaging for community banks, particularly the capital allocations for exposures related to credit enhancing representations and warranties on assets sold or transferred to third parties. Many community banks originate residential mortgages for sale to Fannie Mae, Freddie Mac, or the Federal Home Loan Banks either directly or via third party aggregators. Requiring community banks to hold capital for loans sold to these agencies regardless of claims activity does not properly account for the risks associated with the representations and warranties themselves. If the regulators strongly feel that community banks should hold capital reserves for these representations and warranties, the amount of capital to be held should be directly aligned with a specific bank's history of having to honor claims related to these specific credit enhancements.

Changes to Equity Risk Weights Ignores Current Regulatory Directives. The proposed risk weight changes for equities is problematic for many community bank institutions, especially those with significant equity investments in other financial institutions and other companies that were made pursuant to prudent investment or Community Reinvestment Act purposes. Additionally, certain community banks are permitted to invest a percentage of their capital in the common or preferred stock of other companies at elevated levels pursuant to the Federal Deposit Insurance Act[4]. Specifically, these insured state banks can invest 100% of their tier 1 capital in publicly traded equities when approval is granted by the FDIC. ICBA is concerned that these community banks, which consist mostly of mutual institutions in the New England region, will be needlessly penalized for holding these equity investments when previously approved to do so.

Some community banks make equity investments in their regional banker's banks, where they work together to provide critical financial services to community bank customers. These relationships help expand community bank lending and contribute to sustained economic growth in communities across the nation. The higher risk weights on equities, as well as the penalizing deductions on equity investments in other financial institutions, will greatly curb the ability for community banks to invest in banker's banks. This devastating impact is particularly harmful for those banks that may also currently hold equity investments in other financial institutions including investments in TruPS or other preferred equity securities. **These proposed risk weights for equities are harmful and complex while providing no real strengthening of community bank capital cushions.**

Commercial Lending Under Threat. The proposed standardized approach increases the risk weights for certain acquisition, development, and construction loans known as high volatility commercial real estate. This change to commercial real estate loans represents

[4] 12 U.S.C. § 1831a. Also see 12 C.F.R. §362.3.

an area where risk weights have been impacted negatively with little or no support for a demonstrated need for these activities. These higher risk weights will discourage further acquisition, development and construction lending, further exacerbating the current economic downturn, particularly in the impacted areas. ICBA believes that a sweeping punitive risk weight change for these loans should be abandoned by the regulators. Any concerns that the regulators have with these high volatility commercial real estate loans should be addressed through the bank's risk management policies and validated by the regulator through prudential supervision. ICBA requests that the agencies reconsider the risk weight changes for these assets by retaining the 100 percent risk weight for all commercial real estate loans.

Community Banks Should Stay on Basel I. **ICBA strongly recommends that the regulators fully exempt banks with total consolidated assets of $50 billion or less from all aspects of the proposed standardized approach.** Community banks should be allowed to remain under the current risk weight framework of Basel I for all assets. This accommodation for community banks reflects their superior asset quality, sound underwriting practices, simplified relationship-based lending business model, and existing high quality capital balances.

Alternatively, ICBA recommends that the proposed standardized approach be greatly simplified. For example, community banks should only be subject to the current Basel I risk weights for mortgages or, in the alternative, the proposed category 1 criteria for residential mortgages should be greatly expanded to include all loans with deferred payment features, all loans that do not fully amortize like balloon loans, and all loans that permit increases in principal balance. These loans should carry a risk weight of 50% as long as their loan-to-value ratios at origination do not exceed 90%. For those loans that do exceed 90%, the risk weight should be 100%. The loan-to-value ratios should be adjusted for all credit enhancements including private mortgage insurance coverage. The category 2 criteria for residential mortgages, the majority of which will be second liens, should be risk weighted at 100% unless the loan-to-value ratio exceeds 1.0, where the risk weight should be increased to 150%. If the bank holds both the first and second lien position with the same collateral exposure, the two exposures should be evaluated separately and not combined as proposed.

In addition to the above recommendations for simplifying the proposed standardized approach, we recommend that the risk weights for delinquent loans never exceed 100% regardless of the type of loan unless that loan carried a risk weight in excess of 100% under the current Basel I capital standard. **Furthermore, ICBA requests that the proposed risk weight framework be applied prospectively to all transactions after January 1, 2013 to give community banks enough time and resources to properly reflect the new risk weights in their internal systems.** Under no circumstances should the standardized approach for mortgages be applied retroactively. Regardless of the decisions made on the future of the standardized approach, we are requesting that those banks that are currently permitted to invest their capital in equities at elevated amounts pursuant to the Federal Deposit Insurance Act be permanently exempted from any proposed risk weight changes for investments in equities.

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Minority Bank Preservation and Promotion is Threatened. ICBA notes that these proposed changes to regulatory capital will heavily impact the nation's minority banks, many of which serve economically distressed and underserved communities. Minority banks help to revitalize neighborhoods and spur economic growth in low-to-moderate income communities across the United States. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) charges the banking agencies with preserving the current number of minority banks while promoting and encouraging the creation of new minority banks. It is unclear at this stage what impact the capital proposals will have on minority bank preservation and promotion, or how the banking regulators will reconcile the capital proposals against the provisions of FIRREA.

Basel III is Not Applicable to Credit Unions. Community banks are justifiably concerned that credit unions will not be subject to Basel III or, in lieu thereof, will be subject to much less rigorous capital standards issued by their regulator that will give them, together with their tax exemption, an even greater competitive advantage over community banks. **It is important that both community banks and credit unions be subject to the same capital standards since they compete so intensely for the same customers.** While ICBA realizes that the banking regulators cannot impose new capital standards on the credit unions, we urge them to do whatever they can to level the playing field. Otherwise, credit unions will exploit the competitive advantage they already have and attract customers from community banks with lower rates on loans and higher rates on deposits, significantly impacting the profitability of the community banking industry.

Conclusion

The negative consequences of adopting Basel III and the standardized approach for community banks are abundantly clear. These proposals will do a great deal of harm to all community banks and could eliminate many community banks in rural and underserved areas of the country. These are the areas that rely on community banks to survive and grow. Many areas in the United States will be without banks in their communities as community banks will be forced to merge with other banks and/or stop offering certain loans like residential mortgages. The regulators have not fully assessed the impact of these proposals on community banks and should first conduct a thorough analysis of the expected, best, and worse case scenarios for the U.S. economy if the proposals are finalized as currently drafted. These proposals will lead to lower levels of regulatory capital in all cases, which will weaken capital positions, discourage community bank investment, curb residential lending, and reduce the number of community banks in the United States.

In summary, we strongly urge that the regulators fully exempt community banks from both the Basel III and standardized approach proposals and allow them to continue using the current capital and risk weight framework. If the regulators are unwilling to accommodate this request, we recommend that significant changes to the proposals be made to better align the proposed capital standards to the unique strengths and risks associated with community banking.

For example, AOCI should continue to be excluded in the calculation of regulatory capital, the current tier 1 regulatory capital treatment of TruPS issued by bank holding companies with consolidated assets of between $500 million and $15 billion in assets should continue, and the Federal Reserve should exempt all bank and thrift holding companies with assets of $500 million or less from Basel III and the standardized approach. Bank regulators should allow for the ALLL to be included in the definition of tier 1 capital at an amount up to 1.25% of risk weighted assets while the remaining balance of ALLL should qualify for inclusion in tier 2 capital so that the entire ALLL will be included in a bank's total capital. Bank regulators should continue to allow mortgage servicing assets to be subject to the same higher deduction thresholds that currently apply, and community banks, especially subchapter S banks, should be exempt from the provisions of the capital conservation buffer to the extent that shareholder dividends are needed to pay income taxes. If Basel III and the standardized approach are to apply to community banks, then they should also apply to credit unions.

Most importantly, ICBA strongly recommends that the regulators fully exempt community banks from the standardized approach. The regulators should not penalize residential balloon loans and second liens. Finally, community banks should not needlessly be penalized for making investments in banker's banks.

ICBA appreciates the opportunity to comment on this proposal. If you have any questions or would like additional information, please do not hesitate to contact me at (202) 659-8111 or james.kendrick@icba.org.

Sincerely,

/s/

James Kendrick
Vice President, Accounting & Capital Policy