June 23, 2016

Testimony of

Wayne A. Abernathy

On Behalf of the

AMERICAN BANKERS ASSOCIATION

before the

Banking, Housing, and Urban Affairs Committee

United States Senate

American Bankers Association

Testimony of

Wayne A. Abernathy

On behalf of the

American Bankers Association

before the

Banking, Housing, and Urban Affairs Committee

of the

United States Senate

June 23, 2016

Chairman Shelby, Ranking Member Brown, members of the Senate Banking Committee, thank you for this opportunity to discuss key issues of capital and liquidity in bank supervision and operations. My name is Wayne Abernathy, Executive Vice President for Financial Institutions Policy and Regulatory Affairs at the American Bankers Association (ABA). The American Bankers Association represents the breadth and depth of the banking industry, from the smallest bank to the largest bank, comprehending all of the industry's business models. Capital and liquidity are important to each of these banks.

Capital and liquidity are two of the key indicators on which bank examiners focus and rate banks as part of the supervisory CAMELS system (Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risk). It is hard to overestimate the significance of getting capital and liquidity management right.

This is a timely hearing. We welcome it. We recommend that financial regulators, institutions regulated, and the public served begin to take up the questions—in an orderly, considered, and comprehensive way—as to what works, what does not work as expected, and what can be improved. We envision that this can and should be done in the non-partisan fashion that has long been the tradition of successful bank supervision in the United States. We offer our comments within that context.

As we meet today, the team of global specialists in Basel, Switzerland, are deliberating yet another dozen or more detailed financial regulatory projects, some new, some part of yet another round of adjustments to earlier Basel global regulatory prescriptions. Much like previous Basel projects, neither the American public nor the U.S. Congress have been effectively involved in these Basel deliberations. It is getting increasingly difficult to discern either what their goals are or what value the developing Basel projects have to bring to the U.S. supervisory program.

The latest Basel project for which proposed U.S. implementing regulations are currently pending for comment, is actually one of Basel's older—begun some seven years ago: the Net Stable Funding Ratio (NSFR). The NSFR is a good example of a Basel global prescription for which it is hard to find a valid purpose in the U.S. supervisory program not already amply covered by other regulations and tools, several of which have been put in place since the Basel specialists began their work on the NSFR in 2009. I will discuss the NSFR more at length later in this statement.

We are now in the eighth year of an intensive and extensive financial regulatory reform process. Subjects have included projects affecting capital, liquidity, risk management, stress testing, failure resolution, business processes, compensation, loan-loss reserves, as well as rules and standards for specific product lines, such as mortgages and derivatives. Final regulations, guidelines, and policies have been implemented in all of these areas, with only a few pieces remaining to be applied. In this latter group are rules on Total Loss Absorbing Capacity, executive compensation, as well as counterparty credit limits. These reforms have been accomplished through tens of thousands of pages of regulations and millions of pages of bank compliance reports to their financial supervisors.

All taken together, with the experience of several years of application of the new regulatory regimes, and the publication of the full body of new standards nearing completion, we believe that this is an appropriate point for a review of how it all is working. In the press of reform, each measure has been created and implemented with less than the usual deliberation, and with imperfect reference to the other pieces. It is not credible to assume that each rule and regulation, many of which implement global schemes developed on distant shores for conditions that little prevail in the U.S., is immune to improvement.

It is no criticism of the purpose of any of the reform measures to ask how each is working and to inquire into how all the pieces are working together. The whole substance is not only overwhelming for each individual bank, but we have to believe that it is an awesome weight resting upon the bank regulators who have to supervise how all of the affected banks are applying each and all of the rules. We propose for consideration that there are ways to reduce complexity for banks and supervisors that will result in improved application of the regulatory principles involved. We need to begin that conversation. If not, we may find ourselves with a regulatory program that in practice is too complex to realize the supervisory success to which we all aspire.

GETTING CAPITAL AND LIQUIDITY RIGHT

Today's focus on capital and liquidity brings to the fore factors that affect banks throughout their operations. They also have profound impact on the overall economy. Getting capital and liquidity right is important for local, state, and national economic growth and prosperity, because they affect both the amount of financial services banks can provide and the form that those services take. Economic growth and prosperity, by the way, are the business of banking. Banks prosper as their customers and communities do. Banks devote a lot of time and attention to capital and liquidity management because of their impact on growth and prosperity.

Since the trough of the recession, the U.S. banking industry as a whole has increased equity capital by more than half a trillion dollars. By the end of 2008, the low point of the financial crisis, industry equity capital had receded to $1.30 trillion, from a high point in March of 2008 of $1.36 trillion. At the end of the first quarter this year, bank equity capital had reached a record $1.84 trillion. Other measures of bank capital are comparably elevated, whether risk-based capital measures or risk-blind capital measures like the leverage ratio. Bank liquidity profiles and resources have been similarly augmented.

For U.S. banks, the fundamentals of safety are strong. But are they getting so strong that they are jeopardizing bank soundness? By soundness, I refer to other CAMELS measures, such as earnings and assets. Can a bank have too much capital, and, if so, what are the consequences? Without sustained and strong earnings, no amount of capital and liquidity will eventually be enough. Excessive limitations on assets mean limiting the financial services that banks are chartered by government to provide. There is a balance here, and how to get that balance right is an important matter for policymakers and industry to consider. It is not academic.

CAPITAL IDEAS

We offer a few thoughts for that consideration.

Efficiency of Capital

After the trough of the recession, while the banking industry was building its capital by half a trillion dollars, bank assets—the banking industry's share of the economy—remained flat for several years and then grew by $2.4 trillion. That growth is good and valuable, supporting broader economic growth and millions of jobs. But could there have been more? The new, additional capital has been, at least in the short run, relatively less efficient than normal in generating economic growth. The ratio of new capital to new asset growth has been just shy of one-to-five, each new dollar of capital supporting just under five dollars of new loans, leases, and other bank investments. At the trough of the recession, the $1.3 trillion of bank capital supported $13.8 trillion of loans, leases, and other bank assets and investments; that is to say that one dollar of capital supported almost nine and a half dollars of loans, leases, and bank investments. Encouragingly, the latest results from the banking industry suggest asset growth related to capital moving in a direction toward historical norms. Is that a development for policymakers to arrest or to encourage?

Contractionary Effects

Increasing regulatory capital is contractionary. As we learn in the basics of money and banking, most of the money in a modern economy is generated by means of the banking system, through the process of banks taking in deposits and making loans. The Federal Reserve may create dollars, but depositors take those dollars and put them into banks. Depositors treat their deposit balances as part of the money supply. Banks lend those deposits back into the economy, which funds are used as money by the borrower for economic activity and which find their way back into banks as more deposits, again increasing the money supply, when they are lent yet again. It has been said that modern banking is the process of allowing the same dollar to be used and reused by several different people. Financing banks by deposits is expansionary, funding economic activity. Adequate capital supports that process as a base of confidence and a platform from which to take a chance on borrowers.

But raising capital standards is contractionary, because it takes dollars out of the system. Investors do not treat their capital investments as money. They do not use their capital investments to buy groceries, purchase furniture, go on vacation, or do the millions of other things for which deposited money is used.

That is not to diminish the importance and value of capital as a foundation on which banks are able to build and manage their activities, including that important function of converting deposits into loans and yet more deposits. While adequate capital allows a bank to expand its activities, excessive capital requirements mean pulling even more money out of circulation to provide the same amount of financial services, more capital to do the same amount of financial work. How much capital is really needed, and how do we know?

A Cacophony of Capital Measures

As a result of the variety of new prudential regulations in recent years, we have multiplied the ways in which we evaluate and measure bank capital. The largest banks are required to monitor more than a dozen capital dials, including the Standardized Common Equity Risk Based Ratio, the Standardized Tier 1 Risk Based Ratio, the Standardized Total Risk Based Ratio, the Advanced Approaches Common Equity Risk Based Ratio, the Advanced Approaches Tier 1 Risk Based Ratio, the Advanced Approaches Total Risk Based Ratio, the Leverage Ratio, and the Supplemental Leverage Ratio, among others. To this are added less-well defined but more demanding regulatory capital expectations under annual stress tests, such as the Comprehensive Capital Analysis and Review (CCAR), and a number of capital buffers, including the Capital Conservation Buffer and the Basel capital surcharge for Global Systemically Important Banks (GSIBs).

Surely a case can be made for each measure of capital and the information it provides, or that measure would not have been created and imposed. Do we really need all of them, however? Do so many measures of capital each have equal supervisory value? If they do not, do those measures with lesser supervisory value take some element of attention away from those whose supervisory value is greater, perhaps even vital? Would we improve the effectiveness of supervision if we identified and focused on those measures that provide the most value to prudential supervision? Is now a good time to be asking these questions?

Risk-Based and Leverage Capital

There is a purely academic debate that pits risk-based capital measures against leverage capital measures. In reality, bankers and regulators use both to evaluate the capital condition of banks. Risk-based capital measures have been criticized for being overly complex, subject to manipulation, and prone to error. All of these criticisms have elements of validity. Current Basel III—and other—capital measures are excessively complex, requiring calculations of details that exceed the supervisory value yielded. They do not have to be that way. Measuring capital according to risk can be simpler and still provide enough recognition of variation in asset quality to be a valuable aid to capital management and supervision. Excessive complexity may facilitate manipulation, which is an argument for simplifying the risk measures, not eliminating them. It is easy to point to errors in the risk-based measures, most of which derive from excessive complexity (that presume too fine and precise the degree of risk predictability) and from the static nature of the risk-based measures, inadequately recognizing the dynamic nature of asset risk.

Similarly strong criticisms can be justly applied to risk-blind capital measures such as the leverage ratio. Both risk-based and leverage measures of capital are models. While acknowledging some degree of model error in risk-based capital, it should be understood that the leverage ratio is a model, too, one that assumes that all bank assets present equal risk. Whatever might be said about the likelihood of errors in risk-based measures, we can be certain that the simplicity of the leverage ratio means that it is always wrong. Unless a bank holds only one asset, its portfolio will contain assets with a variety of risks. The 1980s experience with the savings and loan industry demonstrates that this risk-blind simplicity can be manipulated by the unscrupulous to hide the riskiness of assets until the accumulation of risk becomes explosive. The risk-blind capital system that prevailed at that time allowed numerous institutions to run amok and contribute to the destruction of the Federal Savings and Loan Insurance Corporation, which had no measure of the degree of risk building up in the institutions whose deposits it insured.

A more sound capital management and supervisory program makes appropriate use of both risk-based and leverage capital measures, an approach adopted by all U.S. banking regulators and mandated by statute in the wake of the S&L crisis. Risk-weighting of bank assets is indeed imprecise, but it is an art that has shown valuable progress over the years. It avoids the proven dangers of treating all risks the same (under which safer banks are required to hold too much capital, and unsafe banks may be able to pass with too little). To counteract the model risks of risk-based capital systems, however, as well as to ensure capital for risks that are either unknown or unknowable, a foundation of leverage capital is merited. That is the structure that regulators and bankers rely upon today. It is demonstrably superior to reliance on either risk-based or risk-blind measures alone. Inasmuch as risks are dynamic, there is room for consideration of the right balance and improvements.

LIQUIDITY POINTS

Liquidity Is More Perishable than the Rules

Financial instruments are liquid until they are not. There is no class of financial instruments that has not had liquidity issues. Fannie Mae and Freddie Mac securities were once thought so liquid that serious consideration was given to using them as a monetary policy substitute for U.S. Treasuries, should the latter disappear as a consequence of prolonged budget surpluses. The budget surpluses did not last, and neither did the liquidity value of Fannie and Freddie financial instruments. The perceived reliability and liquidity of mortgage-backed securities helped fuel the mortgage/housing bubble. The insolvency problems of the Greek

Government have reminded investors that sovereign instruments can become very risky. Even U.S. Treasury securities are subject to significant market losses in the event of an increase in interest rates, a problem made more acute by the Federal Reserve's prolonged suppression of interest levels, exposing Treasury investors to pronounced market losses from relatively minor upward movements in rates.

Unfortunately, the Basel-prescribed liquidity schemes implemented or proposed for implementation in the U.S. ignore the dynamic nature of liquidity. They are based upon static measures, financial snapshots of current liquidity conditions hardened into virtually perpetual standards. Are there supervisory and management methods to evaluate liquidity more dynamically?

HQLA, Concentration, and One-Way Liquidity

The Basel Liquidity Coverage Ratio (LCR), and U.S. implementing regulations, are intended to ensure that banks maintain enough liquidity to meet their needs for thirty days in a stressed environment. This basic prudential liquidity purpose is one that the banking industry supports. Liquidity, the ability to engage in transactions in a timely fashion and at reasonable cost, is essential to banking. Like oil in a car engine, without enough the engine soon locks up and ceases to operate.

Liquidity management, therefore, has been a perennial focus of bank management and regulatory supervision, part of the CAMELS evaluation for all banks, as I mentioned above. The LCR was promoted as an effort to standardize liquidity supervision for larger banks according to global rules applied locally. Kept at a level of focus on central principles of liquidity management, the global LCR standards could have been useful. Unfortunately, the Basel experts went well beyond that, into micromanaging liquidity supervision. Liquidity problems are all about panic, and panic is a local, idiosyncratic matter. It is affected by local laws, national financial structures, even by local customs and attitudes. Some of these globally-determined details do not fit realities in the United States very well, impacting the markets in which all of our banks operate.

For example, under the LCR, U.S. banks are required to assume that during a recession or financial stress banks will suffer a significant run on deposits. Maybe that was the experience in Europe or other places the Basel experts call home. The U.S. experience has been more generally the opposite. During the recent recession, our banking industry saw an influx of domestic deposits, by $813 billion from immediately before the start of the recession in December 2007 until its official end in June 2009, as bank customers looked to banks as a safe haven to place their money. Yet, under the LCR, U.S. banks are forced to pretend, and engage in liquidity management that assumes a fictitious major run off in business deposits. Large banks are encouraged by the LCR to increase their gathering of retail deposits, in competition with community banks. That is worse than wasteful, as it distorts markets and distracts bankers and regulators from a better focus on what are more realistic challenges to liquidity in the U.S. environment.

That is not the worst problem. The current structure of the LCR is excessively pro-cyclical, likely to hasten and deepen recession. The LCR requires banks to concentrate holdings in a static and narrowly defined list of what are called "High Quality Liquid Assets" (HQLA). The definition is basically short-term government securities, with a smattering of highly-rated corporate debt (deeply discounted). Recently the Federal Reserve added some municipal securities to the definition of HQLA (also deeply discounted), a move not yet echoed by the FDIC or the Office of the Comptroller of the Currency.

If during a time of stress there is not enough HQLA to meet liquidity needs, what will happen? Panic. The LCR makes specific minimum ratios of bank holdings of High Quality Liquid Assets mandatory. What appears liquid today, however, will likely become only one-way liquid in a recession or even the approach to recession. In prosperous times, short-term Treasuries are easy to buy and to sell. In times of stress, who will be willing to let go of their supply? Those that have a supply cannot be sure how much regulators will want them to hold as recession unfolds. Those that do not have enough will have trouble finding it.

If they cannot get needed HQLA, they will be forced to halt any expansion of loans and may even need to shed business in order to keep the mandated ratio of their assets in line with whatever amount of HQLA that they are able to find. Moreover, as noted earlier, U.S. banks typically see an influx of deposits during times of stress, which deposits will be difficult for a bank to accommodate if it is unable to acquire the additional supporting HQLA required by compliance with the LCR (see further discussion, below).

Bear in mind that, at the same time, other regulations will be driving financial actors to acquire and hold these same short-term Treasuries for other mandatory purposes. Recent money market mutual fund rules allow at-par pricing and redemptions only for funds that invest in government securities, and these same government securities are the primary asset recognized by regulations mandating collateral for swaps transactions.

With many sources of demand, HQLA will become scarce when financial storm clouds gather. That scarcity will affect economic activity, accelerating the slide toward recession, and sharpening a recession once begun. Does the static definition of HQLA miss assets that can have important liquidity value under certain circumstances? Is it wise to fix in regulation the assumption that government securities will always be highly liquid under all conditions?

Where Will the Depositors Go?

Banks like to receive deposits and put them to work. A core function of banking is the reception of deposits from individuals, businesses, and government entities. We question the wisdom of liquidity regulations (the LCR) and capital rules (particularly the leverage ratio) that discourage banks from taking in deposits and that make it harder for banks to put those deposits to work.

In particular, these regulations disadvantage business deposits and deposits from municipal governments. The LCR assumes, opposite to U.S. experience, that significant amounts of business deposits will move out of banks during periods of stress. With municipal deposits, the LCR in effect imposes a double charge. Municipal deposits are required by most state laws to be collateralized, however the LCR will require banks to apply additional HQLA if the state-approved collateral does not meet the LCR's narrow definition of "highly liquid." Is it appropriate regulatory policy to discourage banks from accommodating business deposits and municipal deposits, particularly in times of economic trouble? Do we no longer want banks to perform this traditional function?

To this are added punitive capital rules. These deposits are steered into high levels of HQLA, which, if a bank can get the HQLA, provide very low returns to the bank. In the second of a one-two punch, the leverage capital ratio assesses to banks the same capital charge applied to assets with higher returns. Under given market conditions—such as those prevailing today—the earnings on the HQLA may barely, if at all, cover the bank's costs in taking in these deposits. The market conditions that prevail in a recession are likely to be even worse.

The result has already been that some banks have had to refuse deposits and/or charge some businesses fees for holding large deposits. In times of financial stress or even a recession, the supply of deposits seeking a safe haven in banks will likely be elevated (contrary to the regulatory assumptions of the LCR), opportunities to invest those deposits will wane, while bank earnings will be under increased pressure. In short, the new rules compromise the traditional practice of banks to accommodate deposits that they cannot readily use. Where will these depositors go? And what further strain will that place on economic activity? We believe that these are consequences, though already materializing, that neither banks nor policymakers intended. We need to address these dangers sooner than later.

NSFR: Static, Complex, and Plowing an Already Seeded Field

Much of what has been said about the problems with the LCR also applies to Basel's other liquidity prescription, the Net Stable Funding Ratio (NSFR), for which the U.S. implementing regulations were recently published for comment. The NSFR imposes static measures on dynamic activity, and by an order of magnitude the NSFR is more complex than the LCR. Moreover, the NSFR lacks a purpose. There is no problem that the NSFR would solve that is not amply addressed by other prudential regulatory regimes already in operation.

The NSFR requires banks to evaluate their assets according to a complex framework of static risk weightings. At the same time, the rule would require banks to assess their funding sources by another complex set of risk weightings. Then the banks have to compare the two and see what they get. These asset and funding risk weightings, and the regulatory costs that the NSFR would impose, will guide the direction of banking services, rewarding banks for some assets and funding sources, penalizing them for others.

Not only does that increase regulatory allocation of funding, but the risk measures are sure to become swiftly out of date. Unfortunately, like Dorian Gray, the NSFR relies upon an unchanging picture of liquidity while reality changes all around. The liquidity of any asset or liability is subject to variation. The NSFR is not. Based upon the Basel experts' judgment of conditions with which they are familiar, the NSFR would harden risk weightings into regulation and impose them on the future, regardless of what the future may bring.

One of the key themes in the NSFR scheme, is that the maturity of an asset should be more closely matched to the duration of its funding source. To the Basel experts, this may sound like a good idea. It misses, however, one of the important economic roles of banking: maturity transformation. The U.S. banking industry takes in trillions of dollars of very short-term funds—deposits and other short-term debt—which customers take comfort in knowing that they can withdraw as needed. Banks take those funds and lend them out for longer periods, much of them for years. The longer maturities of the loans make houses, cars, and educations more affordable for families by letting them pay over a longer period. Businesses borrow in terms of years to allow the acquisition of plant and equipment, the development of business activities and other projects, most of which take time to generate revenues.

Banks manage the risks involved in the difference between those needs. That is what banks do. The NSFR is hostile to that banking function. It rewards maturity matching, meaning that banks under the operation of the NSFR will be encouraged to lengthen the time that people commit their funds to banks while shortening the maturities of loans.

The banking industry objects, the NSFR being neither in the interests of savers, borrowers, or banks. If finalized as proposed, the NSFR will mean less funding from depositors and fewer loans. We ask whether that is what policymakers intend.

That is not to deny the risk in managing largely short-term liabilities funding longer-term assets. Banks constantly monitor their supply of deposits and other sources of funds, just as they do the conditions of their borrowers. Evaluating how banks perform these duties is one of the central jobs of bank examination.

It has also been the focus of a number of additional regulatory programs put in place over the seven years that the Basel experts have been working on the NSFR. The various regulatory stress tests put bank funding sources and assets through rigorously negative, and dynamic, scenarios to see how they stand up. Weaknesses are identified and addressed. In addition to the LCR, which assumes a severe stress, regulators have developed and apply a Comprehensive Liquidity Assessment and Review (CLAR) to the largest banks, that annually evaluates current and anticipated future liquidity conditions on a dynamic basis. In addition, under form FR-2052a the largest banks daily report their liquidity positions, with monthly reporting for other banks having more than $50 billion in assets. The Federal Reserve's form FR-2052b is employed to monitor liquidity in banks with more than $10 billion in assets but less than $50 billion.

In short, the NSFR would plow ground that has already been seeded by more effective, appropriate, and dynamic measures of short- and long-term liquidity. Can we apply finite supervisory and management resources and attention to more fruitful prudential tasks?

RECOMMENDATIONS

Consistent with these principles and observations, ABA offers the following recommendations.

Highly Capitalized Banks and Basel III

In an overly complex way, Basel III capital rules require banks to hold adequate levels of high quality capital—capital with a demonstrable capacity for absorbing losses. As implemented by U.S. regulators, the final Basel III rules have been in some valuable ways tailored to bank conditions and business models. More can be done.

On September 15, 2014, the American Bankers Association and state bankers associations from every state and Puerto Rico sent a letter to the banking regulators recommending an additional element of tailoring. This recommendation stems from the recognition that a number of banks, primarily community banks, already hold high levels of capital. Recognizing that reality, our recommendation would not require any changes to law or to substance of the Basel III regulations. It would provide relief to thousands of banks, primarily community banks that are already holding levels of capital far and above what Basel III requires. (A copy of the associations' letter is attached to this testimony.)

The recommendation is simple. We recommend that bank regulators recognize that highly capitalized banks, namely any bank that holds approximately twice the level of capital expected by Basel III, be presumed to be in compliance with the Basel III standards without having to go through the complex—and unnecessary—Basel calculations. If you consider Basel risk-based standards, that would be approximately 14% risk-based capital; or if you consider the U.S. leverage ratio, that would be about 10%. We urge that the regulators employ tools already used by banks to identify these highly capitalized banks, rather than create a new onerous process to identify banks that would get relief from another onerous process.

For banks with that much capital, the Basel calculations would be a fruitless exercise, invariably discovering that the bank's capital levels were already far and above what the Basel rules would require. This recommendation would not have application to banks subject to the Advanced Approaches, since that process by definition involves a more detailed level of scrutiny.

We have had several discussions with bank regulators regarding this proposal and have found significant interest. We ask for timely implementation of this important step that would provide important burden relief while fully realizing the purpose of the Basel III capital regime.

Transparency and Due Process for International Financial Standards

The development and implementation of Basel III capital and liquidity standards was a painful process for all involved. It did not need to be that way. The public, the Congress, and the broader U.S. banking industry were brought into the process too late, long after regulatory consensus was hardened, key concepts and formats already developed, and international deals reached.

Moreover, U.S. regulators participated in the international discussions with needlessly limited knowledge as to how the Basel plans would affect U.S. institutions, markets, and the overall economy. By the time that implementing regulations were proposed, U.S. regulators considered themselves committed to the global Basel plan and were reluctant to make more than minor adjustments.

We are still working our way through problems that could have been avoided if addressed at earlier stages in the process and had the regulators been equipped with more knowledge and public input. Examples would include the static and dangerously narrow band of HQLA, the punitive treatment of mortgage servicing assets (that resulted in the shedding of mortgage servicing from banks to nonbank parties whose lower-quality service has been the subject of notoriety, regulatory inquiry, and borrower discomfiture), penalty treatment for investors in banks organized under subchapter S rules (whereby investors in Subchapter S banks that are subject to dividend restrictions to rebuild capital, find themselves paying taxes on dividends never received), and harsh treatment of investments in Trust Preferred securities, TruPS (contrary to congressional intent that existing TruPS investments be allowed to wind down without further regulatory penalties).

ABA recommends that financial regulators adopt or Congress mandate the following administrative practice: prior to the initiation of such international negotiations on financial standards, the U.S. agencies concerned should involve the public, the Congress, and affected industry through the publication of an Advance Notice of Proposed Rulemaking (ANPR). We believe that the ANPR should address and invite comment on the following items, among other pertinent matters—

- The issues or problems to be addressed by international standards;

- The nature of the standards being considered for application in the U.S. or affecting U.S. citizens or businesses;
- The various options likely to be considered; and,
- The anticipated impact of such options on U.S. persons, businesses, and the economy overall.

We believe that this requirement should apply to internationally-developed financial standards in general, whether affecting banking, insurance, securities, derivatives, or other financial products and services.

This would not be an unusual procedure. Regulators often rely upon ANPRs to gather information prior to developing regulatory proposals. Negotiation of international trade agreements normally begins with significant public consultation and congressional involvement. The Basel II capital negotiations involved significant public consultation, improving the approach, providing greater tailoring of application, and collectively enhancing our understanding of risk based capital measures. It is true that the consultations resulted in a pause in potential U.S. implementation of Basel II, but with hindsight it is fair to describe that delay as salutary, since the recession did not catch U.S. banks in the midst of major capital restructuring. The U.S. banking industry entered the recession with a strong capital position that supported continued lending throughout most of 2008, and which industry net capital levels were only mildly impacted in the latter half of that year. Not only would the public and industry be more informed and Congress more involved in major financial policymaking with advance public notice, but the regulators themselves would be operating from a stronger base of information in the international discussions.

The NSFR: Already Done That

The NSFR, discussed above, is at best an outdated proposal that has since been overcome by other and better regulatory structures. ABA recommends that the proposed rule be withdrawn. U.S. regulators should, in fact, find that the purposes—if not the formalities—of the international standard have already been achieved in the U.S. by other liquidity supervisory and management regimes put in place while the NSFR standard was in development.

TruPS and Basel III

Prior to the recent recession it was believed, with regulatory concurrence, that trust preferred securities (TruPS) could serve as an additional and valuable source of capital, particularly for community banks. The recession demonstrated that while that might be true in the case of an individual troubled bank, TruPS had little loss-absorbing capacity when the entire banking sector was under strain.

In the enactment of the Dodd-Frank Act, Congress took two major steps with regard to TruPS and capital. The first was to end the future use of TruPS as capital. The second, to prevent unnecessary harm to the existing issuances and holdings of TruPS by community banks, was to hold existing TruPS harmless, letting them run off as they matured. The regulators tested this congressional purpose in the initial Volcker Rule regulation but subsequently revised their rule to carry out Congress' hold-harmless intentions. Unfortunately, in the Basel III implementing regulations, TruPS are targeted for punitive treatment. ABA recommends that Congress' hold-harmless approach to existing TruPS be applied in the Basel III regulations as well.

Most international regulatory standards, such as those developed by the Basel Committee, are at least initially announced as being designed for internationally active banks. When U.S. regulators choose to expand the reach of these global standards to the entire banking industry—as they did with Basel III—the rules can have a disproportionate and unexpected impact on community banks.

TruPS instruments previously qualified as regulatory capital for the issuing holding company, and are securities in which a number of banks invested in good faith. Some smaller institutions accessed the market for these securities by pooling their issuances with those of other community banks.

Under the pre-Basel III capital regime, most pooled TruPS were assigned a capital requirement based on the credit quality of the pool, using a ratings-based approach. Under Basel

III implementing regulations, however, the U.S. regulators treat any amount of TruPS investments above 10% of a bank's common equity as a loss, deducted from regulatory capital regardless of actual performance. As a result of the Basel III treatment, many hometown banks with TRuPS in their investment portfolios are seeing their capital requirements for their TruPS investments skyrocket.

This treatment of TruPS is inconsistent with the intent of Section 171(b)(4)(C) of the Dodd-Frank Act, which holds harmless existing TruPS investments. That congressional intent was eventually reaffirmed by the banking regulators when they backed away from an initial provision of the final Volcker Rule regulation that required banks to divest their trust preferred securities holdings, forcing thousands of otherwise healthy community banks to consider selling these assets at fire sale prices. About a month later, the banking agencies issued an interim final rule providing relief to banks that had invested in TruPS, citing congressional intent to hold harmless existing investments in the TruPS market. The Basel III capital deduction operates in a contrary direction, strongly encouraging the very divestiture treatment of TruPS investments that was overturned in the 2014 interim final Volcker Rule.

It is not clear why the regulators weighted Congressional intent so lightly, but it is clear that the Basel III treatment should be revisited if congressional intent is to be preserved and existing investments in TruPS indeed held harmless.

SUMMARY

The capital and liquidity positions of the banking industry are strong. The task list of prudential regulatory reform is approaching completion. Some reforms have been in place for several years, some are more recently in place, while a few remain to be finalized. Meanwhile, more and sustained economic growth are needed. The regulatory operations have been taking place on a living patient, whether you refer to the banking industry, the customers served, or the economy overall. We believe that the time is opportune to have a conversation involving all concerned about how all of this is working. What has been effective? What can be more effective? Are there provisions that are not working as expected or intended? We have offered several issues that we hope will be, and need to be, part of that consideration, particularly with regard to capital and liquidity.

The rules are complex, we suggest more complex than they need to be to achieve their important prudential purposes, too complex for regulators and regulated alike. We believe that appropriate and well-considered simplification—with an eye always fixed on accomplishing the purposes of the prudential rules—can enhance both supervision and management. Part of that simplification should include further tailoring of these regulations to the various business models of our very diverse banking industry.

In that context, we offer four specific recommendations, in addition to the issues and questions that we have raised:

1. Banks that are holding high levels of capital should be recognized as already meeting Basel III capital standards, without having to go through the complex Basel III calculations.

2. Prior to the initiation of international negotiations on financial standards, the U.S. agencies concerned should involve the public, the Congress, and affected industry through the publication of an Advance Notice of Proposed Rulemaking (ANPR).

3. U.S. regulators should withdraw the proposed rules implementing the Basel NSFR liquidity regime, having no purpose that is not already met by existing liquidity supervisory programs and tools.

4. The treatment of TruPS under Basel capital rules should hold existing TruPS issuances and investments harmless, as was the intent of the Congress in the Dodd-Frank Act, and followed by the banking regulators with regard to implementation of the Volcker Rule.

The American banking industry is eager to engage in the conversation that we have recommended. Supervision and bank management can be rendered even more effective, which will be better for regulators and the regulated, and for the people whom we all serve.

September 15, 2014

The Honorable Janet L. Yellen
Chair
Federal Reserve Board
Eccles Board Building
20th and C Street, N.W.
Washington, D.C. 20551

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, D.C. 20219

Re: Application of Basel III Capital Rules to Highly Capitalized Banks

Dear Chair Yellen, Comptroller Curry, and Chairman Gruenberg:

The banking industry is firmly committed to effective capital standards that require banks to have adequate levels of high quality capital. We understand this to be the purpose of the Basel III capital standards and the implementing regulations. We embrace that purpose.

For many banks it does not require the implementation regime of hundreds of pages of rules to convert that purpose into reality. Many banks today maintain capital levels far in excess of any amounts that would be required even after a fulsome application of the complex evaluations, measurements, and calculations mandated under the Basel III regulations. For those banks, this considerable and costly work would yield no additional supervisory or safety and soundness benefits. Neither would it provide any service of any kind to any potential bank customer.

We propose that this wasteful and unnecessary effort be set aside, with no diminution in the value of the new capital standards contained in the rules. We propose that highly capitalized banks be allowed to continue to apply existing Basel I standards to the measurement and evaluation of their assets, while applying the new Basel III standards to the definition of what qualifies as regulatory capital. We propose that these highly capitalized banks be defined as those banks that have a common equity tier 1 risk-based capital ratio of at least 14%, measured by the Basel III definition of capital and the Basel I measures of assets that banks have been applying for many years. At 14% a bank would be holding twice the capital that would be required under Basel III, even after the additional 2.5% capital conservation buffer is added to the CET1 risk-based capital standard.

This proposal is not intended to reduce the amount of regulatory capital banks need. It is designed to be a regulatory relief measure for banks that can demonstrate they have significantly more regulatory capital than the new Basel III standards require. We believe that this proposal would reduce regulatory burden for these banks by reducing staff time, outside audit costs and even examination time at these highly capitalized banks. Nor does this proposal require a rewriting of the Basel III regulations; it merely identifies those banks for which the asset measurements of those requirements are superfluous.

When the international capital regime was developed in Basel, these highly capitalized banks were not envisioned. We propose that they not be unnecessarily burdened as the Basel III standards are applied. We seek the opportunity to explore this proposal with you in greater detail at the earliest opportunity, as the demands for applying the full panoply of Basel III implementation structures fast approach.

Sincerely,

American Bankers Association
Alabama Bankers Association
Alaska Bankers Association
Arizona Bankers Association
Arkansas Bankers Association
California Bankers Association
Colorado Bankers Association
Connecticut Bankers Association
Delaware Bankers Association
Florida Bankers Association
Georgia Bankers Association
Hawaii Bankers Association
Heartland Community Bankers Association
Idaho Bankers Association
Illinois Bankers Association
Illinois League of Financial Institutions
Indiana Bankers Association
Iowa Bankers Association
Kansas Bankers Association
Kentucky Bankers Association
Louisiana Bankers Association
Maine Bankers Association
Maryland Bankers Association
Massachusetts Bankers Association
Michigan Bankers Association
Minnesota Bankers Association
Mississippi Bankers Association
Missouri Bankers Association
Montana Bankers Association
Nebraska Bankers Association
Nevada Bankers Association
New Hampshire Bankers Association
New Jersey Bankers Association
New Mexico Bankers Association
New York Bankers Association
North Carolina Bankers Association
North Dakota Bankers Association
Ohio Bankers League
Oklahoma Bankers Association
Oregon Bankers Association
Pennsylvania Bankers Association
Puerto Rico Bankers Association
Rhode Island Bankers Association
South Carolina Bankers Association
South Dakota Bankers Association
Tennessee Bankers Association
Texas Bankers Association
Utah Bankers Association
Vermont Bankers Association
Virginia Bankers Association
Washington Bankers Association
West Virginia Bankers Association
Wisconsin Bankers Association
Wyoming Bankers Association