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FINANCIAL SERVICES

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October 22, 2012

Via Email to Comment Portals

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Re: Capital Rules

Dear Ms. Schwadron, Ms. Johnson, and Mr. Feldman:

We have reviewed the agencies' three notices of proposed rulemaking that would replace the current capital rules for U.S. banking institutions. We do not oppose the proposed capital requirements, but we urge the agencies to exempt community banks from the complex risk weightings and to simplify the Standardized Approach.

The New York State Department of Financial Services ("DFS") recognizes that the notices of proposed rulemaking, as well as the international Basel III framework recommended by the Basel Committee on Banking Supervision ("BCBS"), were developed in response to the recent financial crisis and are properly focused on increasing the quality and quantity of capital within the banking sector.

We agree that an increase in capital requirements is appropriate. DFS supervises, among other entities, numerous domestic banking institutions, many of which are community and regional banks, and all but six of which have assets under $10 billion. Virtually all of our banks will be

able to meet the capital requirements proposed by the agencies. However, DFS has some concerns about the proposed rules, particularly as they relate to community and regional banks. As explained more fully below in response to the questions posed by the agencies, DFS's primary concerns are that:

(1) The proposed risk weightings, as applied to the proposed more stringent capital ratios, result in an additional layer of capital requirements. While DFS supports the first layer of new capital requirements, it opposes the risk weightings as written because they effectively add a second layer of required capital that will disproportionately affect community banks.

(2) The extra burden and cost of compliance and surveillance imposed by the complexities of the proposed risk weightings, if adopted, will not bring commensurate benefits to the economy or stability to the financial sector. Most community and regional banks did not engage in the risky behaviors that led to the financial crisis, and yet, here too, they will be affected disproportionately by the increased complexity.

After providing suggestions to address these concerns, this letter specifically comments on the three proposed rules, ad seriatim: (1) the "Basel III NPR,"[1] which would revise the agencies' minimum risk-based capital requirements for all banks; (2) the "Standardized Approach NPR,"[2] which would revise and harmonize the agencies' rules for calculating risk-weighted assets; and (3) the "Advanced Approaches and Market Risk NPR,"[3] which would revise the alternative advanced approaches to risk-based capital rules for more complex institutions.[4] The vast majority of DFS-regulated banks are subject only to the Basel III and the Standardized Approach proposed rules. We believe it is most important for the agencies to replace or improve the Standardized Approach and that the most effective capital requirements should be simple to understand and apply.

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[1] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action (Docket ID OCC -2012-0008 & RIN 7100-AD87; FR Regulations H, Q and Y, Docket No. R-1442 & RIN 7100-AD87; FDIC RIN 3064-AD95; 77 Fed. Reg. 52792 (Aug. 30, 2012) (to be codified at (OCC)12 C.F.R. Parts 3, 5, 6, et al.; (Board) 12 C.F.R. Parts 208, 217, and 225; and (FDIC) 12 C.F.R. Parts 324, 325, and 362).

[2] Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements (Docket ID OCC-2012-0009 & RIN 1557-AD46; FR Regulations H, Q, and Y, Docket No. R-1442&RIN 7100 AD 87; FDIC RIN 3064-AD96; 77 Fed. Reg. 52792 (Aug. 30, 2012) (to be codified at (OCC)12 C.F.R. Part 3;(Board) 12 C.F.R. Part 217; and (FDIC) 12 C.F.R. Part 324)).

[3] Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule" (Docket ID OCC-2012-0010 & RIN 7100 AD-87; FR Regulation Q, Docket No. R-1442 & RIN 7100 AD-87; FDIC RIN 3064-AD97; 77 Fed. Reg. 52792 (Aug. 30, 2012) (to be codified at (OCC)12 C.F.R. Part 3; (Board) 12 C.F.R. Part 217; and (FDIC) 12 C.F.R. Parts 324, 325).

[4] DFS understands that while the Basel III and the Standardized Approach proposed rules apply to all banks, the Advanced Approaches and Market Risk proposed rules will apply only to some banks that receive regulatory approval to provide model calculations of these risk weights or to use risk weights from recognized sources.

I. Suggestions to Improve Compliance Issues

DFS recognizes the challenge of drafting proposals consistent with the Dodd-Frank Act. However, in conforming the capital requirements to Dodd-Frank, the new guidelines have become much more complex—even compared to the risk-weighted guidelines presented in the BCBS's Basel III proposals to the international community. This complexity creates enormous burdens and frustrations for community banks and DFS believes that the agencies should amend or replace the proposals to address these concerns (which we outline more fully below). Implementing the proposals as they stand now would place regional and community banks at a further competitive disadvantage, with potential ripple effects on the local markets, small businesses, and consumers.

DFS suggests the following:

- **Exception for Community Banks**

  Banks below a defined asset threshold (for example total consolidated assets of $10 billion or less) should be allowed to remain under the same risk-weighting calculations of Basel I while complying with the enhanced Basel III capital ratios. Creating this additional tier should enable compliance costs to be more in line with that expected of smaller banks.

- **Simpler Standardized Approach**

  The agencies should work to make the Standardized Approach simpler. The extensive details in the Standardized Approach impose a heavy burden on community banks. Simpler regulations are more likely to be successfully implemented and reviewed for compliance. We outline below several examples of provisions in the Standardized Approach that could be eliminated or simplified but note that the problem of overall complexity would not be fully alleviated by addressing only these provisions.

Adoption of both suggestions may help allay community banks' concerns that the additional costs to comply with Basel III will be another factor pushing them to consolidate with larger banks. We believe that vibrant community banks are essential to small business development and the health of the U.S. economy. Scaling the implementation of Basel III to bank size serves public policy as it helps prevent deposit concentrations in large institutions, while helping to preserve traditional community banking.

Our specific concerns as to each proposed rule follow.

II. Comments Regarding the Basel III Rules

In response to Question 1 (77 Fed. Reg. 52799), which requests qualitative or quantitative analysis of the proposals, DFS has analyzed the banking institutions that we regulate and found that, subject to the risk weighting system outlined in the Standardized Approach proposed rules, virtually all of them would be classified as "well capitalized" during the initial phase-in. This is not surprising because New York banks have been shifting to a lower risk-weighted asset allocation since 2009. In addition, the majority of these banking institutions would meet the projected guidelines in 2019 for "well capitalized." While most New York banking institutions should be able to meet the new capital requirements, DFS is concerned that the proposals' focus on capital requirements will mean that other measures of safety and soundness will not receive adequate attention.

A. Capital Is Only One Factor Regulators Should Emphasize

In response to Question 6 (77 Fed. Reg. 52804), which requests comments about the proposed capital buffer framework, DFS recognizes that along with the higher risk-based capital ratio and better quality of capital components, the additional capital conservation buffer should provide a further safeguard against institutional vulnerability to financial shocks and future financial crises. However, capital cannot be forever increased, since there are true costs to capital that constrain lending and reduce economic growth. Vigilance is required in analyzing an institution's overall health and equal, if not more, emphasis should be placed on each bank's management and its internal controls, along with thorough examinations, rather than relying on the complex capital models in the proposed rules. While increased capital enhances safety and soundness, senior management competence and integrity, core profitability, internal controls, and reputation are at least as important.

B. Leverage Ratio Should Consistently Be Used With Broader Set of Exposures

DFS supports the proposed retention of the leverage ratio—a 4 percent tier 1 leverage ratio calculated by dividing tier 1 capital by average consolidated assets—and applying it to all bank assets. During the financial crisis, when leverage ratios were not examined, some banks built up excessive leverage but still showed healthy risk-based capital ratios. The leverage ratio can serve as an effective backstop to the risk-based capital ratio: its simplicity makes it less subject to manipulation and it has often proven to be the most effective and restrictive capital requirement.

Indeed, the new supplementary leverage ratio for the Advanced Approaches incorporates a broader set of exposures, including off-balance sheet items, in the denominator. This approach is prudent because it provides a more complete picture of an entity's leverage. Thus, in response to Questions 2–5 (77 Fed. Reg. 52802-03) seeking comments on the supplementary leverage ratio,

to be consistent and avoid confusion the Department supports using the same leverage ratio for the Standardized Approach (see below) as that which is used for the Advanced Approaches, with its broader set of exposures.

C. The Mechanism for Setting the Countercyclical Capital Buffer Should Be Revised

In addition, in response to Question 10 (77 Fed. Reg. 52806) regarding excessive credit growth and the countercyclical capital buffer, DFS believes that adoption of the leverage ratio and supplementary leverage ratio outlined above will address excessive credit growth, and we support the countercyclical capital buffer to reduce systemic risk and avoid a domino effect. However, because economic cycles are difficult to identify and the buffer will be based on lagging economic factors, this buffer may not be adequate. DFS would instead propose: (1) removing decision making from the regulatory panel and relying upon a graduated triggering scheme related to either a simple moving average of banking sector early past-due loans or some other nondiscretionary measure of economic and banking activity; and/or (2) reliance on regulators to annually set the countercyclical buffer to a dynamic percent of risk-weighted assets subject to a floor but primarily based on ongoing regulatory judgment of a prudential buffer sufficient to cover aggregate excess loss potential.

III. Comments Regarding the Standardized Approach Rules

The Standardized Approach is a set of risk measurement techniques proposed to measure and test capital adequacy for all banking institutions. Nearly all of our institutions would be subject to this approach. In response to Questions 1 and 2 (77 Fed. Reg. 52893-94), which seek general comments on the Standardized Approach, we note that the new Basel III capital ratios will increase capital to a level we believe is appropriate to the risks that community banks actually take on in their lending. But then, in addition, the community banks have to apply the new risk weightings from the Standardized Approach, which will produce an additional higher capital charge for our community banks. Therefore, our institutions will have effectively gone through two levels of increased capital requirements based on these proposals.

If the proposed rules are adopted, smaller banks will have a heavier burden because they hold a higher proportion of assets for which risk weightings would be required. By our measure, real estate loans—which will now have higher risk weightings associated with them—make up a larger percentage of the total assets at smaller banks than their larger counterparts. In New York, over 56% of the assets held by banks with total assets of $10 billion or less are lending-related, as compared to less than 31% for banks with assets greater than $10 billion. Furthermore, New York's community banks hold over 10% more in residential loans and roughly 15% more in commercial real estate loans than they did 10 years ago. This increase in loan assets shows our community banks' commitment to lending in the State but it also shows the additional burden they will face in implementing the proposed Basel III risk weightings.

As with the capital holding requirements, DFS is concerned about the ongoing cost and effort for these banks to sustain surveillance on the more complex risk weightings. The risk-weighting guidelines presented in the agencies' current proposed rules are much more granular and complex than the simplified approach introduced in earlier Basel accords. Basel I established minimum capital requirements using simpler guidelines that do not attempt to quantify every situation. The complexities of the current proposals may not produce benefits that justify the costs. Ultimately, we want to ensure that banks are encouraged to focus on making prudent loans rather than sorting through, trying to understand, and comply with impenetrable capital rules.

In the following sections, as DFS responds to additional questions posed by the notices, we outline specific provisions in the Standardized Approach that will likely result in additional compliance costs for many banks while providing minimal or no benefit. This may compel banks to reduce or eliminate certain products and services while passing on additional costs to consumers. But the problem of overall complexity will not be solved by addressing only these provisions; it can only be addressed through a more complete overhaul of the proposals.

This is not the forum to resolve the debate whether overly complex regulations lead to failures of understanding or excuses for not understanding, or the development of labyrinthine methods to get around them, but the upshot for regulators and banks' safety and soundness is the same: complex regulations can lead to compliance failures.

A. Foreign Risk Weights Are Now More Complex and Adequate Data Is Not Available

The proposed rules introduce a new methodology for foreign risk weights in direct response to the Dodd-Frank Act, which does not allow reliance on credit ratings. Question 3 (77 Fed. Reg. 52896) of the Basel III proposed rules solicits comments on this proposed methodology. Many of our banks, including our community banks, hold foreign securities or have other foreign exposures that would be subject to these proposed weights. For exposures to foreign public sector entities, the proposal replaces flat risk weights ranging from 20% to 100% with a sliding scale, expanded to a maximum of 150% to address countries that have experienced a default in the past five years, based on the Organisation for Economic Co-operation and Development ("OECD") Country Risk Classification ("CRC").

Along with the increased complexity, the usefulness of this approach is questionable. DFS is concerned because if a country is not a member of OECD, it will not receive a CRC. In addition, as of the proposal date, risk classifications for Spain, Italy, and Greece are all surprisingly ranked in the lowest risk category, which would result in obligations of foreign banks in those countries receiving a low risk weighting of 20%. This result offers proof of an inadequate classification process. The CRCs also have certain limitations because the data that is relied upon to determine risk weights is not disclosed and may be both outdated and backward-looking.

These new and flawed foreign risk weights support DFS's proposal that banks under a certain asset size should be allowed to remain under the same risk-weighting calculations of Basel I while complying with the enhanced Basel III capital ratios. At the very least, to mitigate the limitations of the foreign risk weighting, CRC methodology should be appropriately disclosed so that banks and their regulators can exercise due diligence upon application.

B. Mortgage Provisions Are Burdensome and May Have Unintended Consequences

In response to Question 5 (77 Fed. Reg. 52899) requesting comments on determining the risk weights of residential mortgage loans (including the use of the loan-to-value ratio to determine the risk-based capital treatment), DFS believes the risk-weighting scheme for residential mortgages is too complex as it requires banks to consider a detailed set of standards when assigning a risk-weight to a residential mortgage. This complexity will impose a disproportionate burden on community banks that rely heavily on mortgage lending.

Furthermore, current capital requirements generally prescribe a 50% risk weighting for residential mortgage exposures. The new risk-weightings range from 35% to 200% based on the complex classifications prescribed by the proposals. The increase in risk-weightings for residential mortgages may have unintended consequences, including the discouragement of residential mortgage activity.

C. Capital Calculations for Assets Sold and Transferred Create Surveillance Issues

With respect to the treatment of credit-enhancing representations and warranties, raised in Question 10 (77 Fed. Reg. 52902), DFS is concerned about the additional capital and surveillance necessary to comply with this proposal. Under current rules, no capital calculation is required when assets (e.g., mortgages) are sold or transferred to third parties with credit-enhancing representations and warranties that contain (1) certain early default clauses, (2) certain premium refund clauses that cover assets guaranteed, in whole or in part, by the U.S. government, a U.S. government agency, or a U.S. government-sponsored entity, or (3) warranties that permit the return of assets in instances of fraud, misrepresentation, or incomplete documentation. The agencies' proposal requires that a 100% credit conversion factor be applied to sold and transferred assets even while credit-enhancing representations or warranties are in place, necessitating additional and burdensome tracking.

Under the proposal, if a mortgage is sold from a bank with full representations and warranties, banks must now account for a "phantom" asset. Keeping track of such an item is not only costly in terms of compliance and surveillance, but also because the additional cost of capital reduces the effectiveness of selling the mortgage and the ability of the bank to issue new mortgages, as one of the purposes of selling loans is to free up capital so that the bank can issue new loans.

This is another instance where the Standardized Approach should be simplified and smaller banks should be allowed to remain with the prior risk weightings.

D. It Is Too Complex to Risk Weight Collateral on Transactions

The use of collateral in transactions is intended to offset the risk involved. Collateral can be applied to any transaction where the credit or lending facility needs to be secured to insure full recovery. While the proposal will permit a banking organization to use the collateral haircut approach to recognize the risk-mitigating effect of financial collateral, the proposed rules require a complex analysis to determine how much of an offset different types of collateral will have. In complying with Dodd-Frank, the previously simple task of assessing collateral based on ratings would be replaced with a complicated matrix of risk buckets.

As demonstrated by the Standard Supervisory Market Price Volatility Haircuts table (77 Fed. Reg. 52911), assigning the offset is complex and depends on numerous different categories including: two types of issuers, each with three ranges of residual maturities, which, in turn, each contain three risk weights. In addition, mutual funds, other public traded equities, main index equities, and cash collateral held will have different percentages. DFS feels that this places an undue burden on banks using the Standardized Approach.

In some cases, additional compliance requirements governing risk weighting of collateral may create a disincentive for banks to obtain collateral, an outcome contrary to safety and soundness objectives.

E. Calculating Risk Weights on Securitizations Without Credit Ratings Creates More Surveillance Issues

Previously, when a bank purchased a securitization, it could account for the asset based on the credit rating of the security, which was determined by the tranche it represented. However, to comply with Dodd-Frank, the proposal replaces the reliance on credit ratings with a long, complicated formulaic approach that will be burdensome for our institutions and will discourage banks from owning these securities.

The proposal replaces the current rating-based approach ("RBA") with a simplified supervisory formula approach ("SSFA"), under which the risk weight of securitization exposures will be based on the underlying assets and the exposures' relative position in the securitization structures. As raised in Question 17 (77 Fed. Reg. 52916), there are challenges associated with meeting the proposed due diligence requirements under SSFA. Although simpler in the Standardized than the Advanced Approaches, SSFA is still very complex, involving several weighted average parameters and attachment-detachment points for the tranche. It is unnecessarily complex and burdensome for smaller institutions and we support a simpler risk

weight methodology for securitization exposures. DFS acknowledges deficiencies in private sector ratings but fundamentally believes private sector risk assessments are likely to be more timely, accurate, and cost efficient than complex risk weighting schemes that will likely have limited ongoing rigorous validation. Therefore, DFS supports the simplification of this provision and the use of Basel I risk weights for smaller banks.

F. Delayed Settlements Are Atypical but Would Be Required to Be Tracked

During the financial crisis, when a large institution failed (i.e., Lehman Brothers), there were delays in trade settlements that adversely affected counterparty banks. Despite the fact that the likelihood of this type of delay is very rare, the proposal requires daily monitoring for their occurrence. This places a burden on our institutions to implement a process and devote significant resources—another example of the complexity of the Standardized Approach, which imposes an unnecessary burden on our institutions.

In this proposed rule, the agencies propose a separate risk-based capital requirement for unsettled transactions—transactions involving securities, foreign exchange instruments, and commodities that have a risk of delayed settlement or delivery. While no additional capital calculation is currently required for unsettled transactions, under the proposal delayed settlement of certain transactions require significant risk weighting (100% – 1,250%) depending on the number of business days after the contractual settlement date. In response to Question 16 (77 Fed. Reg. 52913), which requests comments on unsettled transactions, we counsel against assigning a risk weight to these types of transactions where previously there was none because the separate treatment of unsettled transactions could require a significant ongoing and burdensome tracking process without commensurate benefit.

As noted above, based on our analysis, the vast majority of our regulated banks that would be subject to the Standardized Approach are expected to be well-capitalized under Basel III, which calls into question the need for the proposed additional complexities and reporting requirements we have highlighted here.

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As a final comment on the Standardized Approach, in response to Question 7 (77 Fed. Reg. 52900), DFS supports the agencies' proposal to ease risk-weighting penalties for loan modifications made pursuant to federal or state housing programs. The risk characteristics of loans that require modification under the present economic situation should not have a punitive risk weighting for banks that are willing to modify loans where appropriate.

IV. Enhanced Model Validation Under the Advanced Approaches and Market Risk Rules

In calculating the new risk weightings for use in ratios under the Advanced Approaches proposal, banks have been given leeway, subject to the approval of the banks' regulators, to either provide model calculations of these risk weights or to use risk weights from recognized sources.

We support enhanced model validation for banking organizations using the Advanced Approaches. There are many available models internally developed or purchased from vendors or consultants. But rather than merely endorsing larger banks' internal models, regulators should expect to periodically conduct model validation for capital adequacy tests and, if necessary, require modification to these models. This is especially important in view of the inadequate performance of risk management models and practices at some of the larger institutions during the financial crisis, notwithstanding their previous reputations for sophisticated modeling.

All Advanced Approaches banks should have a comprehensive list of major model assumptions in place for regulators' review.

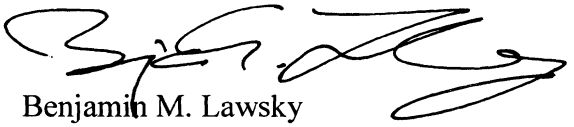
V. Timing

Given the complexity of the proposals, DFS is also concerned about the period of time banks—particularly community banks—will be given to meet the requirements in the proposed rules. Although the phase-in periods should allow banks that need to raise capital sufficient time to secure it, the agencies will need to monitor progress to determine whether additional time is needed, especially with respect to the enhanced capital quality for smaller banks that may not have the compliance resources or ability to raise capital to adequately meet the timelines prescribed.

Conclusion

Based on our experience, simpler rules are more likely to be successfully implemented by banks themselves and more efficiently monitored by their regulators. Again, while we do not oppose the capital requirements, we urge the agencies to exempt community banks from the proposed risk weightings and simplify the Standardized Approach. DFS appreciates the effort on the part of the agencies to adapt the international framework presented in Basel III within the Dodd-Frank Act's parameters and hopes that its comments regarding these proposed rules prove useful in that process. We would welcome the opportunity to provide additional information from the perspective of a New York regulator and to assist the agencies in amending the rules to reflect the experience and fundamentals of community banks, as well as the regional economies they serve.

Sincerely,



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