

**Meeting Between the Board of Governors
and the Community Depository Institutions Advisory Council
April 5, 2013**

Participants: Chairman Ben Bernanke, Vice Chair Janet Yellen, Governor Elizabeth Duke, Governor Daniel Tarullo, Governor Sarah Bloom Raskin, Governor Jeremy Stein, and Governor Jerome Powell (Federal Reserve Board members); Robert Frierson, Wayne Passmore, Louise Roseman, William Treacy, Traci Mach, Lanette Meister, Gavin Miller, Dena Milligan, Wanda Quick, Katie Ross, Brian Tabit, Shahera Williams, and Maureen Yap (Federal Reserve staff)

Chandler J. Howard, Michael J. Castellana, Dennis D. Cirucci, Eddie L. Steiner, Charles H. Majors, Claire W. Tucker, Timothy G. Marshall, Glenn D. Barks, Terry Lobdell, John B. Dicus, Drake Mills, and John V. Evans Jr. (Council members); Robert R. Davis (Consultant)

Summary: The Federal Reserve Board met with the Community Depository Institutions Advisory Council ("the Council"), an advisory group established by the Board to provide input on the economy, lending conditions, and other issues of interest to community depository institutions. One representative from each of the local advisory councils at the twelve Federal Reserve Banks is selected to serve on the Council, which meets twice a year.

The Council discussed the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Act"). Council members noted the statutory mandates for required rulemakings under the Act, but they said the volume of new regulations and the associated compliance burden may cause community banks to stop offering particular products or exit certain lines of business, such as residential mortgages or consumer lending. The Council also expressed concern that the level of new regulatory requirements would encourage further consolidation within the community banking industry. The Council presented its views on the joint notice of proposed rulemaking on regulatory capital requirements (Docket No. R-1442).

The information collected from the Council at the meeting is attached. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

(Comments related to Board rulemakings under the Dodd-Frank Act are provided below.)

Regulatory Capital

Council members are deeply concerned about numerous aspects of the recent Basel III proposals. These proposals fundamentally change every aspect of regulatory capital: narrowing what counts as capital, changing risk-weight calculations, and establishing new required levels of capital. The Council supports the notion of capital reform to help ensure capital adequacy and better alignment of capital with business risks and incentives. However, the Council believes the current proposal falls significantly short of these objectives and would be particularly detrimental for the community banking segment. The following matters are of particular concern.

Mortgage treatment: The Standardized Approach NPR assigns different risk weights to residential mortgage exposures based on (i) whether the mortgage is a first-lien “traditional” mortgage as redefined by the rule (category 1) or other loan (category 2) and (ii) the LTV ratio of the mortgage. Risk weights for category 2 mortgages range from 100 percent to 200 percent, with higher risk weights depending on higher LTV ratios.

The Council believes the categories are inappropriate because they do not focus on an appropriate and necessary consideration of all essential and compensating facts essential to underwriting decisions, whereas community depository institutions excel in this area. If the proposals were to be finalized in current form, the regulators would be encouraging a check-the-box approach to mortgage lending rather than allowing community depository institutions to exercise their judgment about compensating risk factors and the relationship they have built with a potential borrower. The Council feels that the proposals would hurt, rather than help, the residential mortgage market because they do not accurately reflect the actual or relative risk of certain types of residential mortgage loans.

Moreover, the treatment of second mortgages is highly inappropriate. Under the proposal a junior-lien mortgage extended by the same institution that holds a first-lien mortgage on the same property would increase (possibly dramatically) the required capital for the first-lien mortgage. Finally, the Council would like to emphasize that most community depository institutions do not have the data in their systems to apply the complex mortgage treatment. As a result, the Council does not feel it should be adopted as proposed.

Unrealized gains and losses flowing through capital: Under the proposed rule, unrealized gains and losses on available-for-sale securities will flow through to regulatory capital. Unrealized gains and losses occur in an available-for-sale portfolio primarily as a result of movements in interest rates. This change would bring interest rate risk into the regulatory capital standards and greatly increase the volatility of capital ratios. In addition to bringing volatility into the capital calculation, allowing unrealized gains and losses to flow through could create profound risk-management issues (both liquidity and interest rate) and complicate management of lending and investment limits. As a result of the volatility and the potential risk-management issues, the proposed rule should be revised so that unrealized gains and losses on available-for-sale securities do not flow through capital.

Phaseout of Trust Preferred Securities (TPS): Inconsistent with the intent of the Collins Amendment, Basel III does not maintain grandfathered-status for TPS for institutions between \$500 million and \$15 billion. Instead, Basel III requires the phaseout of these instruments for bank holding companies having between \$500 million and \$15 billion in total consolidated assets. In light of the costs of the Dodd-Frank Act and this NPR, all community institutions face greatly reduced alternatives in raising capital. This is particularly true for privately held banks, mutually owned institutions, and Subchapter S Corporations. Phasing out this source of capital especially burdens community depository institutions in their capital plans. As a result, the proposed rule should be revised to fully recognize the intent of the Collins Amendment by permanently grandfathering outstanding TPS for institutions between \$500 million and \$15 billion.

Issue of concern flagged for future discussion - Leverage Ratio: Increasingly, the debate on regulatory capital has centered on a higher leverage ratio. Generally, Council members are deeply concerned about where this debate will lead. The leverage ratio is an extremely good backstop to the risk-based standards but should not be set at a level where it becomes the dominant regulatory capital standard. As this debate develops, Council members may have additional concerns.