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The Honorable Michael Crapo
Chairman
The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing &
Urban Affairs
United States Senate
Washington, DC 20510

Re: Legislative Proposals to Increase Economic Growth

Dear Senators:

Thank you for the opportunity to respond to the Committee's request for input on legislative proposals to increase economic growth. This letter is submitted on behalf of a coalition of community banks adversely affected by the U.S. implementation of the third accord of the Basel Committee on Banking Supervision for capital standards, or Basel III as it is often called.

The Basel III rule has drawn criticism in many respects, but the principal concern is its contractionary impact on the U.S. economy. A precise example of this is the provision requiring banking institutions to deduct the amount of their holdings in Trust Preferred Securities (TruPS) from Tier I capital if those securities represent more than ten (10) percent of total capital.[1]

[1] *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule*, 78 Fed. Reg. 62018; published Oct. 11, 2013, and 79 Fed. Reg. 20754; published April 14, 2014.

As explained in the following section, the reasoning behind the deduction is based on faulty logic and is unnecessarily punitive, given these assets have already been written down aggressively under normal accounting rules. Because Basel III's treatment of TruPS is unjust and has had such a significant adverse impact on community banks and the customers they serve, we recommend that Congress take action to eliminate the deduction so that community banks can recover the capital lost to this provision and once again make it available for customer benefit.

Description of Proposal

Our proposal is simple: Congress should enact legislation to eliminate the capital deduction required by Basel III for TruPS.

By way of background, TruPS are long-term debt obligations that were issued primarily by bank holding companies. They became prevalent in the banking industry when the Federal Reserve ruled in 1996 that a portion of the proceeds from TruPS could count as part of an institution's capital.

Banks which did not have the size or resources to issue TruPS directly into the market often sold them into Collateralized Debt Obligations (CDOs). On the other side of the equation, over 300 FDIC-insured institutions invested in TruPS CDOs since they were highly-rated and diversified bank obligations. During the financial crisis, a number of banks which were issuers of TruPS encountered difficulties or in some cases failed. Since these issuers' securities were included in many of the CDO pools, accounting rules required the investors in TruPS securities to evaluate expected future cash flows and, if necessary, take write downs to their carrying values. Many TruPS investors took significant write downs during the height of the financial crisis due to the performance uncertainty of troubled financial institutions. This means that the carrying values for these securities are much lower than when first issued, which reduces the associated risk with these securities moving forward.

This standard industry accounting treatment worked well as investors recognized potential losses on TruPS investments on a timely basis and their capital was appropriately adjusted. However, under a little noticed provision of the Basel III rules which took effect in January, 2015, an additional 100-percent capital deduction was imposed for TruPS investments exceeding 10-percent of capital. The final rule provided for a four-year transition with respect to the capital deduction which has now entered its third year.

Approximately 25 community banks are covered by this particular provision. They are located in numerous states and especially in Illinois, Mississippi and Wisconsin. Many of these institutions operate in rural areas, have assets of less than $100 million, and are facing a loss of up to 20-percent of their capital. In some cases, these are banking institutions which have been in business over 100 years and have never been less than well-capitalized until Basel III took effect. The TruPS provision threatens their ability to serve their communities and, in some cases, their ability to survive.

No new TruPS have been issued since 2007, so this is an issue which is already working its way out of the banking system. With the health of the issuing banks now stabilized, these securities constitute good, long-term investments with adjustable interest rates.

The accounting requirement for banks to recognize impairment losses on their TruPS investments sufficiently addresses the issue of capital adequacy. The Basel III deduction is onerous, unnecessary and counterproductive and should be eliminated.

Impact on Economic Growth

The amount of capital affected by the Basel III TruPS provision is estimated to be approximately $250 million. A bank's lending capacity is directly tied to its capital levels, and, as a general rule, every dollar of capital in a bank can be leveraged on a multiple of twelve. In the specific context of the Basel III TruPS provision, its elimination would thus result in an additional lending capacity in excess of $2.5 billion.

Moreover, it is important to note that a good number of the affected banks are in rural or other underserved communities. Many are designated as Community Development Financial Institutions (CDFIs) which serve low- to moderate-income areas. For these companies, there is no realistic way to raise new capital and their only option is to shrink the bank or find a merger partner which several of these institutions have already done.

The adoption of the proposal under discussion herein would immediately lead to increased lending for residential and commercial mortgages, apartment lending, small businesses and other areas of capital deployment including municipal financing needs.

Impact on the Ability of Consumers to Participate in the Economy

Perhaps the best way to appreciate this aspect of the issue is to draw upon a specific anecdote. We know, of course, that community banks are disappearing at an alarming rate and the number of FDIC-insured banks has dropped over the last ten years from 9,155 to less than 6,000[2] today.

Insofar as the banks covered by the Basel III TruPS provision are concerned, some, as noted, have already been forced to find a merger partner. One of these cases involved an institution where there was no other independent bank headquartered within a 25-mile radius. For consumers and businesses finding themselves suddenly in a community lacking a hometown bank, the implications go far beyond customer convenience. An entire town and its surrounding

[2] This number, 6,000, is actually an over count as it includes many banks which are not individually independent but are separate bank subsidiaries within the same holding company.

area can be severely impacted by the diminishment of local decision-making on credit availability.

The solution is simple: pass legislation that eliminates the deduction, as detailed in the attached legislative draft.

Other Background Material

In the previous Congress, legislation was introduced to rescind the TruPS provision of the Basel III rule by "grandfathering" banks and bank holding companies which held these instruments as of July 21, 2010. The bill numbers were S. 3500 by Sens. Roger Wicker and Thad Cochran and H.R. 6244 by Rep. Sean Duffy and others.

This proposal has been endorsed by both the American Bankers Association and the Independent Community Bankers of America in testimony before the Senate Banking Committee on June 23, 2016:

> ABA - 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 … 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.
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> ICBA - ICBA urges this committee to support capital relief for community banks, many of them rural-based, that invested in trust preferred securities (TruPS) issued by other community banks. Under the Basel III rule, these investments … that exceed 10 percent of a bank's common equity tier 1 capital must be deducted directly from its regulatory capital. A capital deduction for their TruPS investments will directly reduce their capacity to provide credit in their communities.

In addition, this legislative proposal has been endorsed by the Illinois Bankers Association, the Louisiana Bankers Association, the Mississippi Bankers Association and the Wisconsin Bankers Association.

We thank you again for the opportunity to submit this proposal for the Committee's consideration. Please contact the undersigned with regard to any questions or requests for additional information.

Respectfully submitted,

James J. Butera
Ryan D. Israel
Counsel for the Basel III TruPS Community Bank Coalition

Attachment

A BILL

To require the appropriate Federal banking agencies to treat certain non-significant investments in the capital of unconsolidated financial institutions as qualifying capital instruments, and for other purposes.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. TREATMENT OF CERTAIN NON-SIGNIFICANT INVESTMENTS IN THE CAPITAL OF UNCONSOLIDATED FINANCIAL INSTITUTIONS.

(a) IN GENERAL.—Section 18 of the Federal Deposit Insurance Act (12 U.S.C. 1828) is amended—

(1) by moving subsection (z) so that it appears after subsection (y); and (2) by adding at the end the following:

"(aa) TREATMENT OF NON-SIGNIFICANT INVESTMENTS IN THE CAPITAL OF UNCONSOLIDATED FINANCIAL INSTITUTIONS.—For purposes of the final rules titled 'Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule' (78 Fed. Reg. 62018; published Oct. 11, 2013 and 79 Fed. Reg. 20754; published April 14, 2014) and any other regulation which incorporates a definition of the term 'non-significant investments in the capital of unconsolidated financial institutions', the appropriate Federal banking agencies shall provide that investments in trust preferred securities (pooled and individual instruments) by a depository institution or a depository institution holding company shall not be subject to deduction from the regulatory capital of such depository institution or depository institution holding company or any depository institution holding company of such an institution, provided such investments were held prior to July 21, 2010.".

(b) AMENDMENT TO BASEL III CAPITAL REGULATIONS.—Not later than the end of the 3-month period beginning on the date of the enactment of this Act, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Comptroller of the Currency shall amend the final rules titled "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule" (78 Fed. Reg. 62018; published Oct. 11, 2013 and 79 Fed. Reg. 20754; published April 14, 2014) to implement the amendments made by this Act.