Meeting Between the Board of Governors
and the Thrift Institutions Advisory Council
December 17, 2010

Board members: Chairman Ben Bernanke, Vice Chair Janet Yellen, Governor Elizabeth Duke, Governor Daniel Tarullo, and Governor Sarah Raskin

Council members: Howard Boyle, Ed Broadwell, Barrie Christman, Richard Green, Kay Hoveland, Peter Johnson, Randy Smith, William Stapleton, Dennis Terry

Summary: The Federal Reserve Board met with the Thrift Institutions Advisory Council ("the Council"), an advisory group that is composed of twelve representatives from savings and loan institutions, mutual savings banks, and credit unions. The Council ordinarily meets three times a year to provide the Board with information and views pertaining to thrift institutions.

During the meeting, the Council discussed the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act for savings and loan holding companies, and the Council presented its views on capital requirements and the definition of capital and re-evaluation of risk weights. The information collected from the Council at the meeting is summarized in the attachment. The viewpoints expressed in the attachment are solely those of the Council.

Attachment

3. **Implementing Dodd-Frank for Savings and Loan Holdings Companies:**

a. ***The Dodd-Frank Act transfers supervisory and rule writing authority for savings and loan holding companies to the Federal Reserve in July 2011.***

i. ***Have Council members identified any policy or implementation issues that may affect their institutions or the thrift industry broadly that they want to bring to the Board's attention?***

b. ***The Board must publish in the Federal Register a list of all OTS regulations that it will continue to enforce.***

i. ***Do Council members foresee any particular challenges in reconciling OTS regulations that the Board should take into consideration?***

c. ***Are there any other issues with regard to Dodd-Frank implementation that the Council would like to bring to the Board's attention at this time?***

While it is early in the process, here are some of the issues that the Council would like to bring to the Board's attention.

1. <u>Capital Requirements</u>. While the OTS has not set an across-the-board capital requirement, there have been capital support requirements by supervisory directive. Dodd-Frank ends the customized approach and requires set capital at the holding company level at the same time that some capital techniques such as trust preferreds are being eliminated. Capital requirements have been evolving upward by supervisory requirements, phased elimination of certain formerly-eligible instruments, and the ratcheting up of capital requirements on the international stage. The result is a statutory obligation to be a "source of strength," while the ability of the holding company or the savings association to raise capital has been narrowed. In fact, for mutual institutions, the only opportunity, short of converting to a stock institution, is retained earnings. This makes strategic use of a holding company for capital support difficult. The uncertainty of the capital obligations, the application of "source of strength," and the increased supervisory review of lines of business not normally seen in the bank holding company universe has given rise to a level of concern not seen since FIRREA.

2. <u>Qualifying Instruments</u>. Related to the above concern, there is a need to allow the current holdings of trust preferreds and other formerly acceptable capital instruments to be replaced in an orderly and measured pace. Balance sheet restructuring needs to happen in a manner that supports the savings association and the communities it serves. Abrupt changes cause unnecessary disruption, contract lending, and do not provide a basis for investment. SLHCs urge the Board to use its supervisory flexibility to provide sufficient time for SLHCs to replace capital instruments.

3. <u>Examination Predictability</u>. Recognizing that the Board has a robust holding company examination process, it will be important for the Board to educate SLHCs on what to expect as Board examiners take over that function. To the extent it is feasible, a working group that takes the OTS examination requests (the "Perk kit") and compares and contrasts that with the Board's First Day letter would be useful in identifying issues of

statutory and regulatory differences and examination approach. A comparative analysis of examination differences would assist the SLHCs in understanding examination expectations. The goal of the SLHCs and the Board should be a seamless transition from one regulator to another. Constant and steady communication on fundamental issues as practical and nitty gritty as examinations is one key component to achieving that goal. In addition, the Board should consider hiring OTS SLHC expertise to help BHC examiners understand why approaches differ.

4. Variety of Charters. SLHCs have a variety of charter variations. They are not simply bank holding companies ("BHCs"), but rather may be part of complex holding companies where the financial entities are auxiliary functions to the holding company's holdings. For instance, American Savings is a subsidiary of Hawaiian Electric; Principal Bank a subsidiary of Principal Insurance. Others reflect the variety of state law charters concerning mutuals and mutual holding companies. The concern of the industry, simply put, is whether the Board will embrace the variety of charters and business models, or require the homogenization of charters and elimination of the variety. There are trusts that own savings associations, REITs, privately held entities including Subchapter-S corporations, federal chartered MHCs, and state chartered MHCs where depositors may or may not have voting rights. Given the non-uniform nature of SLHCs, the industry urges the Board to recognize and support the variety and not systematically move the industry toward the BHC model.

5. Intermediate Holding Companies. Because of the diversity of ownership structures, SLHCs are likely to be a group that requires creation of an intermediate holding company. SLHCs encourage the Board to minimize the duplicative nature of yet another holding company structure on top of existing holding company structures and to clarify the capital and source of strength requirements for multiple layers of holding companies.

6. Mutual Holding Companies ("MHCs"). MHCs are an important source of capital for those mutual savings associations or banks that have chosen to use the resource. The structure allows for partial minority conversions to provide responsible growth. For those institutions that have existing minority shares, the MHC dividend waiver provides an effective tool to compensate those minority shareholders for investing and supporting that responsible growth. Dodd-Frank recognized and retained this important waiver tool for MHCs. For many mutuals, the MHC is a no-stock entity that allowed the institution to raise capital through the use of trust preferreds or provided flexibility in the acquisition of lines of business or other banks. Maintaining the flexibility of the MHC charter and recognizing that the charter does not fit into preconceived notions of traditional stock holding companies is important to MHCs that have issued minority shares and to those that have not, but may wish to in the future.

7. Real Estate Concentration. Under the HOLA, savings associations are required to comply with the Qualified Thrift Lender provisions. These necessarily require savings associations as supported by their holding companies to maintain a concentration in real estate assets. Failure to do so is punishable under section 8 of the Federal Deposit Insurance Act. Related to this requirement is the HOLA's and SLHC's ability of holding companies to engage in real estate activities that are not available for bank holding companies. This difference has historically been difficult for the Board. Concerns exist within the OTS universe that statutorily required concentrations may be treated negatively vis-à-vis banks and their holding companies. This may include the possibility

of the Board setting higher capital requirements for the SLHCs to reflect statutorily mandated concentrations – a result that would negatively impact the charters.

8. <u>Data Reporting</u>. Key to focusing examiner attention is the type and frequency of data reported. Previously, the holding company data had been consolidated for the most part with the savings association information. The "teasing apart" of the holding company data and perhaps, the addition of the SLHC data to the existing BHC reporting is cause for concern as systems and programs will need to be changed to produce the requested data in the form the Board prefers. SLHCs will need some time to migrate to the new systems in an orderly manner.

9. <u>Systemically Important Entities and Examination</u>. For those SLHCs that may qualify, it will be important for these entities not only to understand the new rigor applied to their examinations, but also how that level of intensity will impact and differ from existing examinations.

4. Basel III:

a. Capital Requirements:

Basel III raises the minimum requirement for common equity to 4.5 percent and establishes a capital conservation buffer of 2.5 percent. These new capital requirements, along with new and higher requirements with regard to Tier 1 and total capital, will be phased in over the next eight years. Do Council members foresee any difficulties, either for their institutions or for the banking industry generally, in meeting the requirements within this time frame? Will the requirements result in any substantial changes in lending practices?

The Council understands and shares the goals of Basel III as they relate to improving the banking sector's ability to absorb shocks arising from financial and economic stress. We welcome the Committee's decision to provide for a multi-year phase-in period of the new capital requirements and believe that this should mitigate to an extent the risks that a sudden change in capital requirements would hamper economic growth. However, the well-known "announcement effect" of the markets works to counter the effects of the phase-in. On balance, we remain concerned that the increase in capital requirements will limit bank lending and shift bank activities to unregulated or less regulated financial firms. Moreover, the proliferation of buffers, including the capital conservation buffer, countercyclical capital buffer, and supervisory requirements under Pillar 2, are likely to cause institutions to build into their capital planning on a permanent basis extra cushions of capital that may not be warranted by institution-specific or market conditions. These extra cushions would be suboptimal and would constrain institutions' ability to provide credit. Our comments in subsection c. regarding the countercyclical capital buffer further elaborate this point.

The impact of the new capital rules must be considered not only in light of increases in required levels of capital but also in light of a much more restrictive definition of Tier 1 capital and the imposition of buffers over and above minimum requirements. Bank holding companies must phase-out trust preferred securities and find alternative sources of capital to replace those securities. With respect to the treatment of trust preferred securities, we strongly encourage the federal banking agencies to incorporate into its rules the continued inclusion in tier 1 capital of securities issued before May 19, 2010 by depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009 and by institutions that were mutual holding companies on May 19, 2010. These smaller companies are not the institutions that give rise to level playing field concerns at the Basel Committee and, therefore, their treatment under Section 171 should not be problematic from an international competitiveness standard vis-à-vis the other Basel Committee jurisdictions. Moreover, it is important to note that these institutions have much more limited access to the capital markets than do their larger counterparts and would find it very difficult to replace trust preferred funding.

New prudential standards are not limited to Basel III capital rules. The Dodd-Frank Act imposes a number of new restrictions on banks' business models, such as the prohibition on proprietary trading. Proposals for a bank tax, new pending liquidity standards, and other national and international proposals would limit the ability of banks to continue their very important intermediation functions in the broader economy. The shift of these activities to less regulated firms runs counter to the goals of a safe and sound financial system.

b. **Definition of Capital and Re-evaluation of Risk Weights:**

Basel III also tightens the definition of common equity, as well as Tier 1 capital, and incorporates some substantial revisions in risk weights (e.g., for the trading book). How will these changes influence banking activities?

As noted above, the tighter definition of common equity and Tier 1 capital can be expected to make it more difficult for banks to engage in their traditional intermediation activities, to the detriment of the broader economy. The increase in trading book capital requirements (estimated to be three-to-four-fold) will make these activities less profitable and drive down overall profits and return on equity at banks with trading operations, especially when combined with new restrictions on proprietary trading. While we are supportive of efforts to better align capital charges with the riskiness of positions in both the trading and banking books, the dramatic and draconian increases in capital charges that have been imposed are an over-reaction that could impair bank growth and profitability, to the detriment of the broader economy.

c. **Counter-cyclical Capital Buffer:**

What are the Council's views about the 0-2.5 percent counter-cyclical capital buffer established under Basel III? How should such a buffer be implemented in the United States?

We have a number of concerns with the counter-cyclical buffer, which we believe is an unnecessary duplication of other capital buffers and stricter capital definitions. A more flexible mechanism that would determine the need for an additional buffer on a bank-by-bank basis under Pillar 2 would be far superior to the Basel III counter-cyclical buffer. This approach would be more risk-focused and would not penalize prudently managed banks for the excesses of their less well managed competitors, both banks and non-banks. Indeed, the application of the buffer to banks but not to non-bank lenders exacerbates competitive inequalities and has the potential to exacerbate systemic risk.

We strongly believe that the buffer will fail to achieve its primary purpose of mitigating procyclicality, as it will become a *de facto* added capital charge regardless of the stage of the business cycle. Banks generally engage in capital planning over a multi-year horizon. A buffer that can be imposed with a 12-month lead time is inconsistent with bank business practices and creates an uncertainty that banks may need to address by assuming that the buffer will materialize. Maintaining the buffer at all times is suboptimal and inefficient because it would constrain the availability and increase the cost of capital when such a result is not warranted by stress events.

From an implementation standpoint, it is not at all clear how the buffer would be made operational. The country-by-country approach to setting buffers raises important and complicated home-host issues and significant compliance burdens for multi-jurisdictional banks. The definition and calculation of an "exposure" is unclear and there does not appear to be an acknowledgement of the fact that different exposures can have very different contributions to credit overheating in an economy. Determining the "location" of an exposure is also difficult, especially with respect to traded positions and credit facilities that may allocate funds across a variety of firms and jurisdictions.

d. **Loss-absorbing Capacity at Systemically Important Banks (SIBs):**

Basel III establishes the principle that SIBs should have loss-absorbing capacity beyond the new capital requirements. Such capacity might require additional capital surcharges, contingent capital, bail-in debt, or a combination of these. What are the Council's views about the best way to create and calibrate this additional loss-absorbing capacity?

We believe that any mechanism for additional loss-absorbing capacity should be a flexible, bank-by-bank, Pillar 2-based mechanism. A Pillar 2-based mechanism would reflect the business model, risk profile, risk management capabilities, capital resources, and other relevant factors of a bank in light of its need for additional loss-absorbing capacity. A flexible mechanism can also take into consideration the stage of the economic cycle and other macroeconomic factors that may be relevant.