Testimony of

Daniel T. Poston

On behalf of the

American Bankers Association

before the

Subcommittee on Financial Institutions & Consumer Credit
and
Subcommittee on Insurance, Housing and Community Opportunity

of the

Committee on Financial Services

United States House of Representatives

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Chairman Capito, Ranking Member Maloney, Chairman Biggert, Ranking Member Gutierrez, and members of the subcommittees, my name is Daniel T. Poston and I am the Chief Financial Officer of Fifth Third Bancorp, a regional bank based in Cincinnati, Ohio with retail branches in 12 states including West Virginia and Illinois. I appreciate the opportunity to be here to represent the American Bankers Association (ABA) and will testify on the impact that the proposed Basel III rules would have on the entire banking industry and on regional banks like Fifth Third.

ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees. Fifth Third is a typical regional bank: we are a traditional banking organization that is domestically focused, serving our local communities by providing traditional banking services—primarily deposits, loans, and trust and asset management services. We do not have large trading or capital markets businesses. Most regional banks like ours are banks between $50 billion and $250 billion in assets, that are not subject to the Advanced Approaches framework that applies to internationally active banks or "core" banks above $250 billion.[1]

As an industry, we strongly support standards for appropriate levels of high quality bank capital. We also support a more risk-sensitive system of generally applicable rules, one that works well and applies broadly, that identifies risks where and as they are, and that treats similar risks with

[1] I would note that there are three institutions that are traditional regional banks of similar characterisics to our bank and other regional banks but have approximately $300 billion of assets, making them subject to the Advanced Approaches.

similar capital treatment. A strong capital position enhances the ability of the banking sector to serve customers and promote economic growth.

Banks have shown our commitment to increasing and strengthening the capital base in recent years. Even under ***current*** capital standards, capital levels are at historically high levels. In fact, the industry's ratio of tangible common equity to tangible assets (the TCE ratio) ended the quarter at 9 percent, which is the strongest capital level since the Great Depression.

Thus, the issue here is not about higher levels of capital, as it is widely recognized that more capital would have made the financial problems for banks less severe in the last crisis. Rather, it is the complex operation of the Basel III proposals, the volatility of capital measures, and the arbitrary – and excessive – risk weights that will hurt banks, our customers, and the U.S. economy overall.

The proposals related to mortgages, for example, would lead to a significant contraction in the mortgage market, completely upset home equity lending, and further tighten and raise the cost of mortgage and home equity credit for borrowers. Some proposals specifically target many safe and sound mortgage products and services for harsh capital treatment, driving up costs and compelling banks to reduce – or even stop – their involvement in mortgage lending. In addition, the proposals require a significant amount of very granular data on a mortgage-by-mortgage basis. Most banks do not have the required data in their systems to apply this complex mortgage treatment as the proposed risk attribution framework is novel. Small businesses would also suffer, as the proposed rules penalize second mortgages, including home equity loans and lines, which are often used to start-up and support credit needs of these companies.

Changes in the treatment of capital would also have severe consequences. For example, new requirements for regulatory capital will lead to significant unnecessary capital volatility, which banks will have extreme difficulty managing. And the proposal to phase out trust preferred securities is not consistent with current law and would burden community banks that would not easily find ways to replace this capital.

A transition period for implementation—which regulators have proposed—is not the answer to this problem. Implementing fundamentally flawed rules would be a mistake. Moreover, the impact of finalized rules would take effect almost immediately. Investors expect that banks need to meet phased-in capital standards early to eliminate or reduce uncertainty regarding potential future capital issuance. And because mortgages and home equities are typically 15-30 year assets and

contracts, banks cannot allow themselves to put on assets that would only escape punitive treatment for the first couple of years of their duration.

There is a very real cost in holding higher and higher levels of capital. Most disruptive would be higher capital driven by onerous and complex risk-weighting rules that have not been demonstrated to be appropriate or accurate. Many banks will find that the only feasible alternatives are to shrink operations and reduce our service to our existing and potential customers. The result would be fewer mortgages, fewer commercial loans and less flexibility in reasonably pricing our deposit and loan products to our customers.

Rules with the power to create significant economic dislocations must be carefully considered and based on strong analytical research. This was not the case in this rulemaking. ***Therefore, we believe the proposed Standardized Approach should be withdrawn and an empirical study undertaken.*** This will better inform the development of an appropriate set of rules. All banks, large and small, would benefit from an effective but less complex replacement for Basel I. In the desire to make changes, it should not be forgotten that the more complex the rules and the larger the change, the more likely they are to create unforeseen and detrimental consequences to our economy.

We recognize and appreciate that banking regulators have indicated that they will carefully consider the many observations and comments made by the industry. It is our hope that as the banking agencies move forward, they will engage in close consultation with Congress and our industry. We look forward to working with Congress, regulators and others to address these issues, for the good of all.

In the remainder of my testimony, I will concentrate on the following four key points:

- The proposed capital requirements would unnecessarily burden economic activity;
- The proposed risk weights would redirect credit in an abrupt and harmful manner;
- Empirical study is needed to develop capital rules that work for the U.S. banks, large and small; and
- Capital rules for all banks should be simpler and more directionally and proportionally aligned with risks.

I. The Proposed Capital Rules Would Unnecessarily Burden Economic Activity

The industry generally supports the proposed increase in required minimum capital, although we have significant concerns with certain aspects of the definition of capital and the operational aspects of the proposed Basel III capital rule. These proposed requirements would replace the generally applicable capital minimum requirements for all U.S. banks, based on Basel I, which have been in place for several decades.

Increased capital levels are a prudent response to our experience of the past several years, and banking regulators, political leaders, and the public support such increases in generally applicable capital requirements. Increased capital requirements are not free–capital is expensive and that added cost means higher cost of credit for customers. Nevertheless, we generally believe that the proposed minimum levels, if appropriately tailored to risk, represent a prudent balance between safety and soundness and impact to the economy through higher costs and pricing.

Proposed Treatment of Unrealized Gains Would Constrain Banks' Ability to Manage Interest Rate Risk and Liquidity

While the Basel III Capital proposal is generally consistent with the international Basel III framework, we believe U.S. regulators should modify selected aspects of Basel accords for U.S. banks, where appropriate, as they have done with previous Basel frameworks. One of those areas is that unrealized gains and losses on available-for-sale securities have not been included in the U.S. generally applicable capital measurements. We believe—and virtually all U.S. banks large and small agree—that ***excluding unrealized gains and losses is critical to enabling banks to appropriately manage their overall interest rate and liquidity risk***.

Many banks, including Fifth Third, currently have significant net unrealized gains which would actually increase their capital levels under the proposed rules. We believe that in a typical stressed environment such as that experienced recently, the inclusion of unrealized gains or losses in capital calculations would be more likely to increase capital than decrease it. However, we expect that interest rates are likely to increase in the future. When that happens, unrealized gains would likely become unrealized losses and, under the proposal, would decrease capital levels solely due to the impact of the increase in interest rates on securities portfolios. Our recommendation on this matter

is not so much about reductions in capital but instead about banks being able to appropriately manage the overall risk of our portfolios, which include many assets other than investment securities as well as all of our liabilities.

The industry believes that the current exclusion of such gains and losses, which was prudently put in place for these very reasons, should remain in place. Further, banks use these investment security portfolios to prudently manage both interest rate and liquidity risk, and removal of the filter could seriously impact the ability of banks to prudently manage such risks. We also do not believe it would be sensible to institute this change in U.S. rules in advance of new liquidity rules being considered by regulators, which would compound the challenge of managing those rules, and we would ask that it be left out, at least for the time being.

The proposed phase out of Trust Preferred Securities (TruPS) as Tier 1 capital instruments is inconsistent with the grandfathering Congress provided for these instruments (for institutions between $500 million and $15 billion in consolidated assets). These instruments were eliminated as Tier 1 capital for banks larger than $15 billion. The ABA supports maintaining the grandfathered treatment under current law. To invalidate usage now would be a very significant burden to the capital plans of many community banks and would force them into very expensive alternatives to replace what is now working quite well. Community banks face greatly reduced alternatives in raising capital. Many smaller banks have fewer alternatives to raise capital. With limited liquidity for shares and with limited options for obtaining replacement capital, smaller banks would be especially hard pressed to come up with suitable alternatives at a reasonable cost. These banks would potentially find it necessary to shrink to meet the capital requirements, thus reducing lending to businesses and consumers, including residential mortgages and small business loans.

There are other aspects of the Basel III Capital proposal which merit careful consideration and are included in the more than 2,000 comment letters that have been sent to the regulators. We believe these issues have solutions that could be resolved in relatively short order and would be appropriate for all banks, large and small, as is the case under current rules.

Most banks have strong capital positions, well above minimum requirements, for a variety of reasons. However, smaller banks, including especially banks organized in mutual form, have less immediate market access to capital and generally rely on retained earnings to add to their capital. Therefore, the ABA has supported a delay in the application of any Basel III Capital proposal for smaller banks until July 2015, approximately two years after its general application. It is in the

public interest for community banks to be successful, just as it is in the public interest for all banks to have strong capital appropriate to their risks.

II. The Standardize Approach Would Redirect Credit in an Abrupt and Harmful Manner

The higher capital requirements in the Basel III Capital proposal would be expected to raise the price of credit but should not cause a significant redirection of credit flows in the broader economy. ***The Standardized Approach NPR, in contrast, would redirect credit in what we believe would be fairly abrupt and yet un-quantified ways***. We believe it would have a far reaching impact on all banks, small and large, and on their customers.

The ABA strongly recommends that the Standardized Approach be withdrawn and that careful empirical studies be conducted to evaluate its attribution of risk and its impact to banks, borrowers, and the economy. At Fifth Third, we support this approach, as do other regional banks like ours. This standardized risk weight framework of capital attribution was never considered or proposed in previous forms of standardized approaches. Banks were informed of these proposed risk attributions in June, and it has proven extremely difficult for them to even estimate the complex interactions the proposed rules would have on their risk weighted assets. Some have provided these estimates to the market, though without much detail, and as a result there is still no basis to actually estimate the impact of the Standardized Approach to the industry overall or to most of its participants.

The industry provided thousands of comments to the agencies regarding this proposal. While all the issues of importance are too numerous to discuss, it is worth noting that, in addition to the problems detailed throughout this statement, ABA and its member banks are particularly concerned that the proposed Standardized Approach:

- Mismatches risk among asset classes;
- Risk weighs non-performing loans lower than some performing loans, including certain home equity loans and lines;
- Causes risk weights under the rule to exceed the value of the asset.

The Proposed Framework Will Have Significant Negative Impacts on Mortgage Availability

The proposed framework for risk-weighting mortgages is based upon ***qualitative*** attributes of loan products that create the potential for risk, without considering other key underwriting factors, the appropriateness of the loan for that borrower, or the credit-worthiness of the borrower. These factors, along with loan-to-value ratios (LTVs), were the actual dominant causes of differential loss experience during the crisis, as they have always been. As such, banks' management of risk is oriented toward those very factors. They manage risk and pricing, using LTVs, debt-to-income ratios, credit scores, and other measures known to provide strong prediction of credit risk. The product types that are appropriate for borrowers differ, based on borrower preferences and these attributes. Assigning risk to product type before considering underwriting ignores the key role of underwriting in determining risk and product appropriateness. Previous standardized risk-weight proposals were much less complex and much more aligned with identified sources of risk, and we encourage the revisiting of those proposals.

Key concerns outlined in industry and individual bank comment letters include the assumption that many traditional hybrid ARM mortgages and many mortgages with balloons or interest deferral periods have double the risk of other loans.[2] We fully agree that some mortgages are riskier than others—for example, mortgages with higher LTVs, higher debt-to-income, and lower FICO scores are generally riskier than the reverse—but we do not believe that loans with the above attributes are automatically risky and all of them are certainly not twice as risky as other mortgages.

While we believe the proposed framework for categorizing mortgages is problematic***, the effect of the proposal on home equity loans would be profound.*** This is because of the impact of home equities on the risk weightings for first mortgages, held by a lender that also made or makes a home equity loan to the same borrower. Home equity lines of credit have been found to have performed relatively well during the crisis, likely because they tended to be provided to relatively higher

[2] Banks are very concerned about the treatment of balloon mortgages, particularly given their importance as an effective interest rate risk management tool. These loans also provide a means to balance property prices and affordability, which is especially difficult in higher cost states like New York and California. In fact, in some areas, such as rural communities, balloon loans are the only product that may be offered. Importantly, many banks can demonstrate that, when properly underwritten, balloon (and interest-only) loans have a strong historical performance. The evidence that balloons can be made safely makes for a very strong example against an assumed automatic high risk weighting for them. We do not believe that treating these loans punitively is justified unless the banking agencies are able to prove that such mortgages are risky despite proper underwriting. Adjustable rate mortgages, likewise, enable banks to hold them while protecting against interest rate risk, while also being a product that is appropriate for and desired by certain consumers.

quality borrowers.[3] However, they often have one or more features that would cause them to be assigned to "Category 2" attracting double risk-weightings. (These common characteristics for home equity lines include floating indexed rates, interest-only periods, and / or balloon maturities.) The proposal requires home equity loans and first mortgages made by the same lender to be combined for purposes of evaluating the loan-to-value of both the first and second lien (despite the first lien having a lower LTV and having priority right to the collateral), and using the category of the second lien to determine that of the first (despite the senior lien not having any such characteristics and being fully senior to the junior lien).

First lien mortgage loans are usually much larger than second lien loans and, therefore, this methodology can and will cause small home equity loans to double (or more) the risk weighting of a first mortgage on the same property (because of the risk-weighted asset inflation it causes to the first mortgage). The effective risk weighting for such a home equity loan could easily be in the many hundreds of percent.[4] In contrast, a junior lien provided by another lender would be risk weighted at its direct risk weight of 100-200 percent. We believe this disparity may make it impossible for banks to provide competitive home equity products at a reasonable price to their own customers, despite there being no difference in risk for the home equity loan based upon who provides it.[5] Home equity loans and lines of credit are commonly provided to borrowers for many purposes, including small business investment. These purposes are important to the economy, and utilize part of the borrower's net worth in the form of equity they have built in their homes to conduct these activities. In short, we believe this combining of first and second liens should be eliminated from a re-proposal, except in the cases of piggybacks, and first and second mortgages risk-weighted independently.[6]

There are other aspects of the Standardized Approach for which we believe the industry has made constructive comments, including aspects of the treatment of early default guarantees for sold mortgages, "high volatility commercial real estate" (HVCRE) and securitization treatment. These

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[3] Donghoon Lee et. al., Federal Reserve Bank of New York, August 2012.
[4] Because this is so counter to economic reality and experience, it is also a prime example of how the Standardized Approach would produce very different results than under the Advanced Approaches, which is based upon economic reality and experience.
[5] A lender subject to the Standardized Approach in competition with a lender not subject to it would have difficulty competing for certain mortgages or home equities at all.
[6] We suspect that a concern about piggyback lending – issuing and funding a first and second lien simultaneously to a customer to reduce down-payment requirements – is the source of this aspect of the proposal. We and the American Bankers Association (and its joint comment letter partners) have proposed instead that simultaneously funded first and second liens be the only loans that are combined for determining the applicable LTV for the first mortgage. These borrowers should not be penalized to address a form of risk that can instead be addressed directly.

have been detailed in comment letters by the ABA, a regional bank working group that includes Fifth Third, as well as other letters including those from individual banks. We would be happy to provide the subcommittees with these documents and details on these other important issues.

III. Empirical Study is Needed to Develop Capital Rules That Work for All U.S. Banks

The ABA strongly recommends that the Standardized Approach be withdrawn, and that studies be conducted to evaluate its attribution of risk and its potential impact on the mortgage market, the economy, banks and their customers. We believe an empirical study of the Standardized Approach would inform the better development of an appropriate set of new rules.

We believe it is critical that any proposed changes to how banks calculate their risk weighted assets be directly aligned with actual risk and risk experience. ***A capital proposal that does not build on risk experience will redirect credit away from loans and borrowers even where the risk is appropriate for them and the lender.*** We believe it is not possible to create a set of rigid rules that fully capture the key elements of underwriting. The more complex the rules, the more likely they are to create unforeseen issues.[7] As a result, we believe an appropriate standard set of risk weights must necessarily be simpler than what has been proposed.

As of yet, it is not possible to evaluate the competitive or customer impact of the risk-weighting approaches on groups of banks or on their businesses like mortgages. Banks have only recently estimated (or are estimating) the impact, but that data has not been collected, aggregated, and then its results applied for consideration of how the "Collins Amendment" floor[8] would work or how capital buffers would and should be calculated. These issues should be evaluated through study. Just as the largest banks are concerned about competitive balance internationally, domestically focused U.S. banks are concerned about domestic competitive balance. The mortgage business is so vitally important to all banks, large and small, that if the mortgage activities of any of them are constrained through prescriptive risk-weights for certain types of risk, those constraints

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[7] For example, we understand there are non-U.S. banks (not subject to the Standardized Approach) who are investigating opportunities to acquire (at significant discounts) from U.S. banks mortgage or home equity loans which would receive punitive treatment under the rules. They would risk weight these mortgages at, say, 35 percent, or perhaps even re-securitize them to be carried at an even lower risk weight. ***Such a development would represent the transfer of value, and capital, from U.S. banks to non-U.S. banks, without a commensurate reduction in risk that would justify it.***

[8] Dodd Frank Act, Section 171 (b)(2).

should be common. A balloon mortgage or traditional ARM loan should not be more costly to make for a smaller bank than a larger bank. This is not only important for competitive reasons, but because the customers of any bank with different restrictions would also be affected differentially through no fault of their own.

We believe it would be useful for banking regulators to also evaluate the work and findings related to the FDIC's rulemaking on high risk consumer loans, which capture important elements of underwriting that are not incorporated in the approach taken with this proposal.[9]

IV. Capital Rules for All Banks Should Be Simpler, and Directionally and Proportionally Aligned with Risks

The Basel III Capital NPR and Standardized Approach NPR are proposed to apply to all U.S. banks whether or not they are internationally active. This approach – that there should be a set of common capital rules that apply to all U.S. banks operating domestically – is consistent with the current approach which has applied to such banks for decades. All banks use the same definitions for each type of capital, are generally governed by the same U.S. capital requirements, and, for a given type of risk, each bank is required to hold the same amount of capital for that risk. These factors make it critical that such a system be appropriately designed and one that all banks can implement.

Any change should represent an improvement on Basel I. ***A more risk-sensitive risk-weighting framework would be valuable in the U.S., but if mis-calibrated it could be very damaging.*** Such a proposal should be consistent with risk, be exceptionally careful not to over-ascribe risk, and not be overly complex or difficult to implement. If risk-weightings are not truly correlated with actual risks, risks would shift inappropriately among banks or to and from the banking industry to nonbanks that may be less regulated and more difficult to regulate.

Banks of all sizes, from the largest banks to community banks, have expressed remarkably consistent concerns with the substance of the proposals. The proposal for new risk weightings is overly complex and does not build on an analytical foundation from demonstrated experience, and we believe it would lead to market distortions that are neither necessary nor desirable. The added complexity of the proposed Standardized Approach has the ***appearance*** of accuracy and

[9] This was a point made by a group of regional banks in commenting on the proposals. Assessments, Large Bank Pricing, 77 FR 18109 (March 27, 2012).

sophistication, but we believe the reality is far different. It would be more appropriate to emphasize the role of appropriate supervisory oversight and judgment, rather than creating highly complex risk-weighting frameworks that are untested and unlikely to be correct either at the beginning or over time as markets change.

The implementation of a proposal of such complexity would affect all banks, and the customers of all banks, significantly. The administrative and logistical burden of data collection, management, reporting, and compliance alone would be very high for any bank. This burden is primarily related to the sheer complexity of the operations of the proposal, rather than its inclusion of greater risk sensitivity. However, as burdensome as the rules would be to implement, that burden would pale in comparison to the impact on business activities and customer disruption for any bank to which they applied, as they tried to manage conflicts where there was high attributed risk and much lower actual risk.

As proposed, the rules are overly complex and need to be simplified and aligned with risk so that they can work for all banks. As written, the proposed rules are not appropriate for banks of any size. In fact, application of any new rules based solely on the size of the bank inevitably would lead to distortions that cannot be justified by the risks taken by the institution. For example, some observers have suggested that the proposals only apply to banks greater than $50 billion, which would include banks like Fifth Third. We believe there is absolutely no reason that the proposed rules would be appropriate only for banks of our size (or larger), in the absence of any special propensity shown for taking risks or holding risk concentrations.[10] Again, banks should be required to hold similar capital for similar risks, whether they are large or small institutions. We believe a replacement for Basel I that works for smaller banks would work just as well for larger banks, including regional banks.

The appropriate way to address this is for the rules to be withdrawn, studied and, if necessary, re-proposed, in a simpler form more directionally and proportionally aligned with risk. We believe until such rules are identified and applied that would work for all banks, small and large, the current Basel I rules should remain in place for all banks.

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[10] Banks of our size, as well as the largest banks, already are subject to extensive and detailed scrutiny of our risk, at granular detail, through stress-testing and other processes. In our bank's opinion, by rule, these data reporting, capital planning and stress testing processes are far more strenuous than will ever be required for smaller institutions. Furthermore, institutions that have $50 billion in assets are already subject to very significant "cliff effects" despite the small size of our institutions relative to the banking sector or economy.

Summary

In conclusion, the ABA believes the proposed Standardized Approach should be withdrawn until further study. The issue is not whether U.S. banks have the capital for these rules—the vast majority of banks already do. It is the complex way the rules would work that would be so damaging to all banks, the mortgage market, and most importantly our customers. Therefore, careful study to ensure consistent and workable rules for all is absolutely critical given that this proposal is not required under any Basel agreement or any federal legislation.

The industry supports a more risk-sensitive system of generally applicable rules, one that works well and applies broadly, that identifies risks where and as they are, and that treats similar risks with similar capital treatment. There are nearly 7,000 banks in the United States, the vast majority of which are community banks; therefore any general risk-weights must work for these banks, or else they don't work. We believe that such an approach would be entirely appropriate for regional banks, like Fifth Third, and the risks they take as well.

Banks large and small have voiced very strong and remarkably consistent concerns about its operation of the Standardized Approach, its complexity and burdens. We urge that these concerns be carefully considered and we very much appreciate that the banking agencies have indicated they will do so.

Lawmakers, banking regulators, and bank employees are all under incredible pressure to implement many changes in the way banks are regulated in the U.S. Replacing the generally applicable rules for risk-weights is a complex process, and requires that regulators and the industry communicate and work together to calibrate risk-sensitive rules appropriately, and have the time to study and align them. This approach would better to ensure that resulting impacts to credit flows and economic activities are desirable and appropriate in both direction and scope.

The ABA appreciates the opportunity to present these views to the Subcommittees for your consideration. We look forward to working with you, regulators and others to address these issues, for the good of all.