Written Testimony of America's Mutual Banks

Joint Hearing before the
House Financial Services Subcommittees on
Financial Institutions and Consumer Credit
and
Insurance, Housing and Community Opportunity

Examination of the Impact of the Proposed Rules to Implement Basel III Capital Standards

Thursday, November 29, 2012

America's Mutual Banks ("AMB") appreciates the opportunity to provide this testimony to the House Financial Services Subcommittees on Financial Institutions and Consumer Credit and Insurance, Housing and Community Opportunity regarding the joint proposed rules issued by the Federal Reserve Board (the "FRB"), the Comptroller of the Currency ("OCC") and the Federal Deposit Insurance Corporation intended to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision (the "Proposals"). AMB is an unincorporated association whose membership consists of banking institutions organized under the mutual form of ownership. AMB's membership consists entirely of community based institutions dedicated to serving their communities and fostering the economic growth of those communities. Community based, mutual form institutions are a historically vital part of the fabric of many communities and their future viability must be protected and enhanced. Unfortunately, as presently proposed, the impact of the Proposals on AMB's members and mutual form institutions generally will be harmful and possible systemically threatening.

In their attempt to address broad market concerns, the Proposals paint with too broad a brush and sweep community based mutual form institutions into the same regulatory scheme as systemically large stock form institutions. Mutual form institutions do not have permanent capital stock like stock form institutions and, therefore, do not have permanent stockholders. We are concerned that the agencies do not truly understand the value, nature and unique role of mutual institutions. We believe that without an in depth understanding, the agencies may miss the impact the Proposals will have on mutual institutions.

While the Proposals present much to comment on we will focus on two primary issues, fluctuations in capital calculations and the need for alternative capital enhancement for mutual institutions.

Capital Calculations. In the Proposals the agencies stated that "Most of the capital of mutual banking organizations is generally in the form of retained earnings (including retained earnings surplus accounts) and the agencies believe that mutual banking organizations generally should be able to meet the proposed regulatory capital requirements". Unfortunately, this statement is premised on a snapshot in time. While generally accurate now, it does not take into account the increased uncertainty and volatility in asset management, earnings and capital calculations which the Proposals themselves create.

The Proposals create the likelihood of wide fluctuations in earnings and capital calculations by institutions. The Proposals provide that unrealized gains and losses on all available-for-sale ("AFS") securities held by an institution would flow to and be included in the calculation of Common Equity Tier 1 Capital ("CET1"). The agencies proffered that such an approach "would better reflect an institution's actual risk". However, the agencies also acknowledged that temporary changes in the market value of securities could create substantial volatility in an institution's regulatory capital ratios, possibly even triggering prompt corrective action. Given the present interest rate environment, it is virtually certain that rates can only rise from where they are today, and that means the market value of securities held will be negatively impacted. Not only can this arbitrary movement (which in most instances the institution has no ability to influence or control) in the market value of securities negatively impact an institution's capital ratios, it quite possibly will negatively affect a mutual community bank's ability to lend and manage its risk. The de-facto mark to market of AFS securities will manifestly increase volatility which will make the capital ratios of mutual community banking institutions fluctuate and harder to maintain. Amplifying the fluctuation of the mutual bank's capital calculations is the provision in the Proposals increasing the risk weighting of various residential and other loans originated and held by institutions. This provision may impact mutual banks more due to the fact that they generally hold loans in portfolio in greater percentages than larger banks and substantially more than the systemic banks. A mutual bank's asset portfolio generally consists of approximately 70% 1-4 family loans compared to approximately 25% for all other financial institutions. This portfolio concentration in mortgages is generally mandated by federal requirements under the qualified thrift lender test and the Internal Revenue Code. An additional element of the Proposals which will negatively impact capital is the full deduction from CET1 of equity investments made by mutual state savings banks in traditional investments which are not permissible for national banks. These investments have been traditionally included in Tier 1 Capital by such institutions. Further, the Proposals capital conservation buffer will restrict discretionary bonuses to executives which is the only means of rewarding successful management of a mutual bank due to the mutual bank not having the ability to provide equity based compensation. As a result of economic and market forces beyond their control, mutual institutions will be forced to adjust their asset portfolio's to account for this increased volatility without the ability to tap the capital markets like stock institutions to support what could very well be more profitable operations. As a result of the increased uncertainty and volatility in asset management, earnings and capital calculations which the Proposals themselves create and without the ability to raise capital beyond retained earnings, many mutual banks may have to curtail growth plans and reduce services to their communities in order to husband capital to meet unexpected future needs which they can neither foresee nor control.

One sure way to avoid the problems discussed above is to exempt mutual institutions from the Proposals entirely. While organized for historically different reasons, mutual form banks and credit unions share a common foundation; they are non-stock form. All credit unions are organized as co-operatives which is essentially the same as the mutual form of organization. However, the Proposals do not apply to credit unions. This irony is an example of the "one size fits all" approach to banks. Credit unions are exempt because there are no systemic aspects relating to them and it is accepted that they did not contribute to the recent banking crisis. Mutual form community banks, the largest of which is one sixth the size of the largest credit union, also are not systemic and did not contribute to the recent banking crisis. Yet, they are being included

in the rules developed for systemically important banking institutions. Thus, exempting mutual banks would be the most sensible and fairest approach.

Alternative Capital Enhancement. If exempting mutual banks is not a viable approach, then the agencies should at least consider an alternative capital enhancement method. As stated above, retained earnings are the primary method by which mutual institutions raise capital. However, the Proposals not only do not provide for alternative methods for mutual banks to raise capital, they will effectively eliminate two long standing and legally permissible capital formation methods available to mutual banks; pledged savings accounts and mutual capital certificates. In light of the foregoing, and notwithstanding that mutual institutions are generally some of the highest capitalized banking institutions, AMB believes that in order to be prepared and to be able to comply with the new and evolving capital standards and changing economic conditions it is imperative to establish alternative methods by which mutual institutions can raise capital which will qualify as CET1 capital. Such capital can be used to grow the institution, expand operations, act as a buffer against the continuing downturn in the economy, finance acquisitions and for other corporate purposes.

The Basel Committee focused almost exclusively on stock form banks in establishing the capital requirements under Basel III. Certain criteria and other terms intended to apply to stock form institutions are not appropriate in gauging the risk profile of mutual form institutions. Ironically, the application of these criteria and terms to mutual banks will increase the risk to the deposit insurance fund rather than decrease it. As stated in footnote 12 on page 14 of Basel III, the Basel Committee acknowledged that it is appropriate for the specific constitution and legal structure of mutual institutions to be taken into account in applying Basel III to them. Effectively, it is being left to national regulators to determine exactly how the new requirements will be applied to mutual institutions. Clearly, the regulators have the latitude to develop a regulatory scheme which does not hinder the viability of mutual institutions, even if it is different from that developed to address large systemic banks.

The European Commission's Capital Requirements Directive IV published in July, 2011 offers a degree of flexibility. This has encouraged central bankers and regulators in the EU to work with and make an effort to accommodate mutual institutions with capital requirements that will comply with Basel III and be compatible CET1 capital.

As was discussed in an article in the American Banker/Bank Think, dated October 3, 2012, perhaps the farthest along are the British Building Societies. The proposal which has emerged is for the issuance of "core capital deferred shares" or CCDS. Nationwide Building Society, Britain's largest, pioneered the way this past May by obtaining approval in principle from the British Financial Services Authority of the CCDS as a CET1 instrument.

What is needed is a proactive collaboration between the FRB, OCC, FDIC and the mutual banking industry, through its representatives such as AMB and the national and state associations, in designing and customizing a CET1 capital instrument for use by mutual institutions. Additionally, all involved in this process must realize that any capital instrument designed to meet the requirements of CET1 must also be marketable and sustainable or the capital enhancement will merely be an academic exercise with no real possibility for successfully

augmenting loss-absorption capital and achieving the goal of stronger institutions and a stronger industry. With that thought in mind, AMB has proposed an alternative capital instrument to be available to mutual institutions. This alternative capital instrument for mutual institutions has enough characteristics under GAAP to qualify as CET1 non-withdrawable capital, which protects the mutual institution and the deposit insurance fund, yet contains no features that are inconsistent with the mutual nature of the institution or jeopardize the tax deductibility of the income payments. The deductibility of the income payments is particularly important to be able to offer an instrument that is economically attractive to both the issuer and the investor. In this regard then, AMB proposes the establishment of a non-withdrawable mutual investment certificate that would have the following characteristics:

- No voting rights, except that holders of the instruments have the right to elect two directors upon the sixth missed interest payment, upon a change of control and upon changes in the capital structure of the bank;
- No holder may put the instrument back to the bank;
- Redemption solely at the bank's discretion;
- Income payable may be fixed or variable or tied to an index;
- Income is payable if and when declared by the board of directors, subject to the capital requirements of the Basel III Proposals;
- Income payments are cumulative;
- Perpetual--no maturity date;
- Repayment is subordinate to the claims of creditors and depositors;
- Convertible into shares of common stock upon a mutual to stock conversion of the bank based on a fixed exchange ratio basis based on the investor's ownership percentage at the time of investment.

AMB believes that adoption of the non-withdrawable mutual investment certificate will safely permit mutual form institutions to enhance capital if it should be necessary while still achieving the agencies objectives of increased loss-absorption capital.

We would note that Congressmen Michael Grimm (R-NY) and Peter King (R-NY) have introduced H.R. 4217, the Mutual Community Bank Competitive Equality Act, which provides, among other things, for authorization for mutual institutions to issue mutual investment certificates which would be eligible for inclusion as Tier 1 Capital.

Conclusion. AMB respectfully requests the Subcommittees to urge the agencies to further investigate the impact of the Proposals on mutual institutions. AMB has a responsibility to its members and to their depositors, members and communities to express its belief that if left unchanged, the Proposals could severely negatively impact the mutual banking industry in this country. AMB strongly believes that by working closely with the agencies, an acceptable resolution can be fashioned. The continuing viability of mutual form institutions should be a common goal which together can be achieved. As discussed above, AMB believes that its

proposal to develop a non-withdrawable mutual investment certificate will enhance significantly the continued vitality of the mutual banking industry and increase the capital cushion protecting the deposit insurance fund.

AMB appreciates the opportunity to provide this testimony to the Subcommittees on this very important issue. We would welcome the chance to further discuss these comments at your convenience.