PAUL
HASTINGS

1(202) 551-1896
kevinpetrasic@paulhastings.com

October 22, 2012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
regs.comments@federalrserve.gov
Docket No. R-1442, RIN 7100-AD87

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, DC 20219
regs.comments@occ.treas.gov
Docket ID OCC-2012-0008/0009, RIN 1557-AD46

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
comments@FDIC.gov
RIN 3064-AD95/96

Re: Proposed Regulatory Capital Rules

Ladies and Gentlemen:

We are writing on behalf of our client, an FDIC-insured depository institution, to comment on the joint notices of proposed rulemakings ("NPRs") on Regulatory Capital Rules issued by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation (the "Agencies"), as published in the Federal Register on August 30, 2012.[1] Our comments address concerns with issues raised by two of the NPRs – the Standardized Approach NPR and the Basel III NPR – on four specific topics:

- The inclusion of Accumulated Other Comprehensive Income ("AOCI") in regulatory capital, particularly with respect to certain high-quality securities, does not achieve the aim of lowering risk in the banking system; rather, it may encourage more risk taking.
- Categorizing adjustable rate mortgages ("ARMs") as higher risk Category 2 loans if the rate can increase more than 2% in a year is inconsistent with other provisions of the

[1] Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements, 77 Fed. Reg. 52887 (August 30, 2012) (the "Standardized Approach NPR"); Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52791 (August 30, 2012) (the "Basel III NPR"); and Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule, 77 Fed. Reg. 52977 (August 30, 2012).

proposed rule, particularly where the lifetime interest rate cap is lower than other similar ARM products.

- When a lender holds both the first and a junior lien mortgage and no other lender holds an intervening lien, both mortgages must meet the standards of a Category 1 mortgage or the entire exposure is treated as if it were a Category 2 mortgage, thereby penalizing lenders who are in a better position to manage risk by holding both loans compared to the first lien lender where the second lien loan is held by a different lender.
- Categorizing all interest-only loans as higher risk irrespective of credit metrics is arbitrary and fails to take into account actual loss and risk experience.

Inclusion of AOCI in Regulatory Capital

In the Basel III NPR, the Agencies are proposing to include a bank's AOCI in regulatory capital. In our view, and as noted by other commenters, this would cause institutions to be overly sensitive to the impact of benchmark interest rate changes on regulatory capital irrespective of the credit quality of existing balance sheets. As a consequence, institutions could be motivated to mitigate this sensitivity by substituting higher risk loans for otherwise safe, low-risk holdings that are subject to valuation fluctuations driven solely by changes in benchmark interest rates. Specifically, this would create a counter-productive choice for banks either to maintain significant holdings of short-term securities to minimize interest rate risk, resulting in mismatches between assets and liabilities under the NPR, or to hold higher risk loans to avoid mark-to-market charges to regulatory capital. This would have exactly the opposite impact of the presumed intent of the Capital Rules, which is to reduce risk and appropriately calibrate risk sensitivity.

The Agencies recognize this in the Basel III NPR by noting that "including unrealized gains and losses related to certain debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate could introduce substantial volatility in a banking organization's regulatory capital ratios. The potential increased volatility could significantly change a banking organization's risk-based capital ratios, in some cases, due primarily to fluctuations in a benchmark interest rate and could result in a change in the banking organization's PCA [prompt corrective action] category."[2] In addition, including AOCI in regulatory capital creates an implicit conflict with the rules regarding the Liquidity Coverage Ratio ("LCR"). Conflicting policy objectives are evident where a bank holds certain high quality liquid securities for purposes of the LCR but then is penalized for unrealized gains and losses on such securities due to interest rate fluctuations through the inclusion of AOCI in regulatory capital. Again, the Agencies acknowledge this "could introduce substantial volatility in a

[2] 77 Fed. Reg. 52811.

banking organization's regulatory capital ratios,"[3] and "recognize that such volatility could discourage some banking organizations from holding highly liquid instruments with very low levels of credit risk even where prudent for liquidity risk management."[4]

A particular concern with the fallout of these various conflicting policies is the potential impact on retail banking platforms. Including AOCI in regulatory capital would penalize institutions that have a high percentage of retail deposits and high credit quality securities. Consider a bank with a current capital ratio of 8%, no wholesale funding, and retail deposits with an effective duration of 3%. If that bank holds half of its assets in high quality securities with an effective duration of 1.5%, and its remaining assets (including loans) have an effective duration of 2%, it will be financially better off if interest rates increase. For example, everything else being equal, the value of the firm's equity (assets less liabilities) would increase more than 30% if interest rates increase 400 basis points. Under the Basel III NPR, however, the institution's regulatory capital ratio would deteriorate almost 25%.[5] Clearly, this is an irrational result; but given the current very low interest rate environment, it is reasonable to see how interest rates will eventually rise and these events could unfold.

Based on the issues highlighted above, and in response to the Agencies' request for comments on "alternatives to the proposed treatment" of AOCI, we believe it would be appropriate to exclude certain high quality liquid assets from the AOCI regulatory capital calculation, including, as the Agencies suggest, U.S. Treasury Securities, U.S. Government Agency securities, mortgage-backed securities and debentures issued by a U.S. Government Sponsored Entity ("GSE"), and possibly other high credit quality and liquid securities exhibiting the same or a similar risk profile. To the extent that these securities exhibit no or minimal credit risk and are sensitive only to interest rate risk, including continual changes in their market value in the calculation of regulatory capital will significantly over-emphasize interest rate risk to the exclusion of other risks. In our view, this is clearly an unintended consequence that should be avoided.

Classifying ARM's as Category 2 Loans When the Rate Can Reset More than 2%

Another issue that we want to highlight is the proposed treatment in the Standardized Approach NPR of certain ARMs that may reset more than 2% in the year after expiration of the fixed rate term. Currently, the most common form of ARM in the market place is the so-called "5/2/5" ARM, which allows the interest rate to increase as much as 5% in the first year after the fixed rate term, and 2% in any succeeding year, but no more than 5% over the life of the loan. Under the Standardized Approach NPR, 5/2/5 ARMs would be treated as "Category 2" loans because the annual interest rate can increase more than 2% during the first year after the fixed term.

[3] *Id.*
[4] *Id.*
[5] This reflects the regulatory capital impact at the fully phased-in level.

While the basis for this treatment appears to be the supervisory concern related to potential credit risk arising from payment shock that could result where the existing interest rate increases more than 2% during a 12-month period, this fails to take into account that all such loans are expected to be underwritten at the fully indexed rate,[6] taking into account the borrower's ability to repay the loan, including the possibility of payment shock. Pursuant to interagency guidance, "underwriting standards should address the effect of a substantial payment increase on the borrower's capacity to repay when loan amortization begins," and "an institution's analysis of a borrower's repayment capacity should include an evaluation of their ability to repay the debt by final maturity at the fully indexed rate, assuming a fully amortizing repayment schedule."[7] These criteria are directed specifically at concerns related to the potential impact of ARM adjustments on the ability to repay, i.e., credit risk. Thus, it is unclear what policy objective is being furthered by a requirement placing a 5/2/5 ARM into an inherently riskier category than a 2/2/5 ARM from a credit risk perspective where the terms of the 5/2/5 ARM loan should already take into account the relevant risk factors at the time the ARM was underwritten and originated.

In this regard, we are not aware of any empirical data indicating that 5/2/5 ARMs have twice as much credit risk as so-called "2/2/5" ARMs, which cap 12-month interest rate increases at 2%.[8] Again, because both ARM types are being underwritten at the fully indexed rate and payment shock is required to be taken into account at the time of underwriting, the basis for any distinction is questionable from a policy standpoint. Moreover, treating one type of ARM product as twice as likely to fail as another type of ARM suggests a policy that is not reflective of what should be the true economic picture based on a borrower's creditworthiness as determined by the underwriting of the loan.

An important point with respect to this issue is that the Standardized Approach NPR imposes an unreasonable capital burden on one of the most popular products in the marketplace. It is noteworthy in this regard that, in the same discussion of the 2% 12-month cap on Category 1 mortgage exposure characteristics, the Agencies reference several other factors clearly focused on ability to repay and ensuring that a mortgage loan is generally underwritten at the fully indexed rate. As noted above, we believe this screen is the appropriate measure for assigning

---

[6] *See* "Interagency Guidance on Nontraditional Mortgage Product Risks," published at 71 Fed. Reg. 58609 (October 4, 2006). In addition, pursuant to DFA § 1411, ARMs are required to be underwritten at the fully indexed rate; however, this requirement does not become effective until implementation by the issuance of a final rule by the Bureau of Consumer Financial Protection ("CFPB"). Pursuant to DFA § 1400, the CFPB is required to issue a final rule by July 21, 2013, which must become effective no later than January 21, 2014.

[7] *Id.*

[8] Notwithstanding the lack of comparative data on 5/2/5 versus 2/2/5 ARMs, we note that it has been our client's experience that delinquency rates (30+ days) for 5/2/5 ARMs have been approximately 17% lower relative to delinquencies for 15-year and 30-year conforming loans. This suggests a very different experience than what the proposed risk weightings would reflect for these respective mortgage loan products, and certainly with respect to the divergent treatment of 5/2/5 and 2/2/5 ARMs.

risk-weighting for mortgage loans, including various types of ARM products. Accordingly, we urge the Agencies to utilize those factors and to eliminate the 2% 12-month cap particularly where an ARM has a lifetime cap of 5% .

Based on all of these factors, we believe that sound and compelling policy considerations support modifying the Standardized Approach NPR to provide that 5/2/5 ARMs, like 2/2/5 ARMs, should be treated as "Category 1" loans under a final rule. In response to Questions 5 and 6 of the Standardized Approach NPR, while we recognize that bright lines are important and beneficial to insured depository institutions in assigning risk weighting for regulatory capital purposes, we note that such measures often create arbitrary classifications that are not truly reflective of risk. Accordingly, we urge the Agencies to consider refinements that take into account better calibration tools where assigning risk weights between two categories often turns on minor points or considerations that are not determinative of actual credit and/or interest rate risk considerations. At the same time we note that there may be certain other characteristics that could be used to create presumptions for risk weighting or allow for an override of other loan characteristics when assigning risk weighting. Chief among these, as highlighted in the proposal, is the loan-to-value ("LTV") ratio for a mortgage loan. As discussed below, it is should be clear that a 5/2/5 ARM with a 50% LTV ratio would have a substantially lower risk of default than a 2/2/5 ARM with an 80% LTV ratio; however, the NPR would assign a 100% risk weight for the 5/2/5 ARM and a 75% risk weight for the 80% LTV 2/2/5 ARM. This is an inequitable result both from a policy and practical standpoint.

Treatment of Combined First and Junior Lien Exposures

When a lender holds both the first and a junior lien mortgage and no other lender holds an intervening lien, the Standardized Approach NPR would provide that both mortgages must meet all the requirements and standards for a Category 1 mortgage or the lender's entire combined mortgage exposure would be treated as a Category 2 loan. As a result, to the extent that most junior lien mortgages will be treated as Category 2 loans because of the 2% 12-month cap on interest rate changes, where a lender holds both loans its entire combined exposure would be treated as a Category 2 loan and subject to significantly higher risk weighting regardless of the combined LTV ratio for such loans.

Under the NPR, a first mortgage exposure that meets the standards of a Category 1 loan with an LTV ratio of 80% will have a risk weighting of 50%. The same first mortgage loan backed up by a junior lien subject to Category 2 treatment (e.g., because of the 2% 12-month cap), would have a risk weighting of 100% even if the combined LTV ratio for both loans is 30% (or any percentage amount between 0 and 60%). However, if the junior lien is held by a different lender, the first lien mortgage would be treated as a Category 1 loan (with a 35% risk weighting if the LTV ratio is 60% or less). This is an irrational result from a policy perspective that bears no reasonable basis to the actual risk of default to the lender from a combined loan exposure. This is particularly evident where there are factors that indicate the risk of default is less for a combined mortgage holder extending the exact same (combined) amounts for a first and second lien at a lower LTV ratio compared to a first lien mortgage holder extending the exact same amount (as the combined loans) but at a much higher LTV ratio. In the latter circumstance, a first lien holder extending a $200K mortgage loan would be subject to a 75% risk weighting for an 80% LTV ratio loan whereas the same combined $200K extension of credit at a 50% LTV ratio would result in a Category 2 risk weighting of 100%.

Analyzed another way, the exact same extensions of credit at the same LTV ratios (on an individual and combined basis) by the same lender would result in dramatically different risk weightings notwithstanding minimal differences in the risk of default to such lender. For example, a $200K mortgage at an LTV ratio between 80% and 90% would result in a single first lien mortgage with a 75% risk weighting, whereas a combined $180K first lien mortgage and $20K floating rate second lien loan by the same lender at the same combined LTV ratio would result in a 150% risk weighting. Again, this appears to be a distorted assessment of the actual risk of default reflected by these two very similar lending positions.

Also troubling regarding the relative risk weighting is that unsecured loans appear to be assigned a maximum risk weighting of 100% under the proposal, while a combined first lien and secured junior lien mortgage issued to the same borrower by the same lender would receive a <u>minimum</u> risk weighting of 100% and a possible maximum weighting of 200%. It is counterintuitive that an unsecured lending position would receive a <u>lower</u> risk weighting than a well secured combined lien position.

Based on all of these factors, sound policy advocates that it is appropriate to decouple the capital treatment of combined first and junior lien exposures set forth in the NPR. A first lien mortgage should not be treated as a Category 2 loan merely because of the existence and characteristics of a junior lien mortgage loan issued by the same lender. As demonstrated above, there are compelling policy considerations regarding why the first lien mortgage in such circumstances should be treated the same as any other first lien mortgage. Moreover, the experience of the financial crisis suggests that, in many cases, holding the first and second lien position may actually benefit a first lien holder – as well as the borrower – where a borrower faces difficulty making payments. In our view, this bolsters the public policy rationale supporting the separate treatment of combined first and junior lien exposures.

<u>Treating All "Interest-Only" Loans as Category 2 Loans</u>

The final issue that we want to address is the blanket treatment in the Standardized Approach NPR of all "interest-only" ARMs as Category 2 loans. While payment option ARMs that have the potential for negative amortization played a role in the recent financial crisis, it is our experience that, if underwritten properly, interest-only loans are a safe, viable and attractive mortgage loan product for certain borrowers who have strong credit profiles. A number of these existing and potential borrowers are our client's customers. While we understand the intent of the more stringent Category 2 risk weighting for "interest-only" ARMs, again, we suggest that too broad a brush is being utilized for the sake of creating bright lines that allow for easier calculations for risk weighting and capital calculation purposes. In this regard, it has been the experience of our client that the relationship of the Category 2 risk weighting of interest-only loans relative to Category 1 risk weighting for different LTV levels is typically not an accurate reflection of relative risk of default.

For example, going back to our preceding senior/junior loan discussion, it is unreasonable to assume that an interest-only loan with an LTV ratio of 30% would have twice the risk of a 30-year fully amortizing mortgage loan originated at a LTV ratio of 80%. Presumably, the interest-only loan would be reclassified as a Category 1 loan when the applicable interest-only period ends (although the NPR is silent on this issue); thus, it is unclear why all interest-only loans should be classified as Category 2 loans during the interest-only period. We believe that no differentiation should be made based solely on whether a loan is interest-only. In this regard, it has been the experience of our client that LTV ratios are a compelling factor that should override a Category 2 classification for certain interest-only loans. For example, our client's experience indicates that delinquency rates on interest-only loans with LTV ratios less than 60% are substantially lower than (almost half) the delinquency rate of non-interest-only loans with LTV ratios between 80% and 90%. Yet, the NPR would assign a risk-weighting of 75% to the latter group of mortgage loans and a significantly higher 100% risk weighting to the first group.

Further amplifying our concern regarding the proposed treatment of all interest-only loans as Category 2 loans is the strong disincentive this would create for banks currently – and safely – offering this product. There continues to be a number of borrowers with a strong interest in the interest-only mortgage and, assuming that such loans are appropriately underwritten and offered to qualified borrowers, it is unclear what policy objective is served in curtailing this market by creating lender disincentives via unfavorable risk weightings. In some cases, borrowers may have a strong preference for an interest-only mortgage, and lenders that are able to offer such products with a demonstrated history of low delinquencies should be able to do so without being penalized for a risk that is not present. Lenders such as our client, that underwrite interest-only loans based on the full principal and interest criteria and, as a result, have an interest-only delinquency rate that is one-quarter the delinquency rate for all mortgage loans nationwide (including interest-only and non-interest-only mortgages), should be able utilize other factors (e.g., LTV ratio, FICO score, etc.) to override a Category 2 assignment for an interest-only loan where it is clearly appropriate to do so.

While we continue to believe that there are strong public policy reasons why all interest-only loans should not be summarily classified as Category 2 loans, we urge the Agencies to clarify that – if the NPR remains as currently proposed – such loans become eligible to be reclassified as

Category 1 loans (assuming all other applicable Category 1 criteria are satisfied) when the interest-only period ends.

* * * * *

Thank you for the opportunity to comment on the above referenced regulatory capital proposals. We welcome any further questions or issues you may want us to address or clarify regarding our comments and we are available to provide any additional information you may require regarding the information provided herein.

Sincerely,

Kevin L. Petrasic

Kevin L. Petrasic
of PAUL HASTINGS LLP