October 9, 2012

The Honorable Ben S. Bernanke, Chairman
regs.comments@federalreserve.gov
Docket No. R-1430; RIN 7100 AD87
Docket No. R-1442; RIN 7100 AD87

Re: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action

Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements

Federal Reserve Board:

Thank you for the opportunity to provide comment on the Basel III proposals[1] that were recently approved by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively the "banking agencies").

Sterne, Agee & Leach, Inc. is a full service investment banking and broker/dealer firm headquartered in Birmingham, AL and founded in 1901. We have over 200 institutional fixed income professionals working in 14 cities. We work with depository institutions across the country on a range of issues including fixed income portfolio management, interest rate risk management, credit analysis, capital raising and M&A activities.

As we have explored the proposals and their implications within the industry, we have collected a list of comments from our client base and are incorporating these into this comment letter. When appropriate, we provide suggested alternatives. Please note that this letter is also being submitted on behalf of the undersigned clients, whose signatures are located at the end of the document. Below is a summary of items for which we provide comment:

1. Trust Preferred Capital Treatment
2. Available for Sale Inclusion in CET1
3. Cash Flow Hedge Adjustment
4. Residential Mortgage Loans

[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions*; *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements*; and *Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

5. Non-Significant Investments in Unconsolidated Financial Institutions
6. Simplified Supervisory Formula Approach

Trust Preferred Capital Treatment

Despite the clear exemption within the Collins amendment for institutions under $15 billion in total assets, the proposal requires all institutions under $15 billion (not exempt by the Small Bank Holding Company Policy Statement) to deduct trust preferred instruments from Tier 1 capital based on the phase out schedule provided[2].

For a wide range of small-cap institutions, trust preferreds have served as an important source of capital. Additionally, these same institutions have found it quite difficult to raise capital in the current environment. In the case of small privately held C-corporations or Sub S corporations, access to capital markets is undoubtedly constrained. Furthermore, despite the grandfathering of TARP or SBLF instruments under the proposal's framework, the contractual terms of these government investments requires a fairly significant elevation in the coupon to be paid over the upcoming years. As a result, most institutions remaining within these programs have been planning exit strategies for those instruments prior to the release of the NPR's. The effects of both the coupon elevation on legacy TARP/SBLF instruments and the possible exclusion of trust preferred instruments from Tier 1 capital has severe consequences. These two timelines overlapping combine for a large capital need over the foreseeable horizon in a portion of the industry that has limited access to the capital markets.

Consequently, we would encourage the agencies to remain consistent with the intent of the Collins amendment and allow for grandfathering of existing trust preferred instruments for institutions under $15 billion in total assets.

Available for Sale Inclusion in Tier 1 Common Equity (CET1)

According to the proposal, unrealized gains and losses on all AFS securities would flow through to CET1. This would include those unrealized gains and losses related to debt securities whose valuations primarily change as a result of fluctuations in a benchmark interest rate, as opposed to changes in credit risk.[3] Undoubtedly, this requirement will add a significant amount of volatility to capital ratios. The grid below illustrates just such a situation:

AFS Investment Portfolio Effects on CET1					
		Shocked Effects on the Tier 1 Common Equity Position Via Available For Sale Portfolio			
	Existing Position	UP 100	UP 200	UP 300	UP 400
Market Value	$304,971,646	$295,433,986	$282,723,691	$268,195,195	$255,936,378
Book Value	$296,917,857	$296,917,857	$296,917,857	$296,917,857	$296,917,857
Unrealized Gain/Loss	$8,053,789	($1,483,871)	($14,194,166)	($28,722,662)	($40,981,479)
Unrealized Gain/Loss (post tax)	$5,073,887	($934,839)	($8,942,325)	($18,095,277)	($25,818,332)
Tier 1 Common Equity	$66,076,000	$60,067,274	$52,059,788	$42,906,836	$35,183,781
Change in Tier 1 Common Equity		($6,008,726)	($14,016,212)	($23,169,164)	($30,892,219)
CET1 Ratio	8.69%	7.90%	6.85%	5.64%	4.63%

Durations per scenario range from 3.5 to 4 yrs
Resulting impact on CET1 is substantial

[2] NPR Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action Pages 98-99

[3] NPR Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action Pages 49-50

As shown, the CET1 ratio of this hypothetical institution (AFS portfolio represents approximately 35% of total assets) declines substantially in rising rate scenarios (parallel yield curve shifts). In fact, the CET1 ratio nears the 4.5% minimum required in the UP 400 bps shock. Clearly, the asymmetric sensitivity of the capital account to rising rates could prove troublesome in the current environment.

Several consequences emerge as a result of attempting to strategically manage the capital position assuming this rule is adopted. Institutions will likely trend towards greater use of the held to maturity (HTM) designation. However, this action will limit an institution's ability to hold a cushion of marketable liquid assets, thereby hindering its liquidity position. Additionally, for most institutions, the investment portfolio is used heavily as a mechanism to manage an institution's overall interest rate risk sensitivity, shortening or lengthening duration/cash flows when necessary to affect the balance sheet's global sensitivity. A reclassification into the HTM account will constrain an institution's ability to influence the interest rate risk position efficiently. Also, for those institutions maintaining an allocation within the AFS portfolio, they will likely target much shorter durations in order to mute any ancillary effects the portfolio may have on the capital position. This will not only compress the yield naturally achievable by longer duration products (in a steep yield curve environment) but also exacerbate certain balance sheets' rate risk sensitivity (e.g., organically asset sensitive institutions). One could argue that each of these results is counter to the ultimate goal of creating and preserving capital (through retained earnings and balanced risk profiles). Finally, the ancillary effects of this declining demand from financial institutions for longer duration products, such as municipal bonds, could prove detrimental to smaller municipalities' ability to efficiently fund themselves.

We would argue that inclusion of the AFS adjustment within capital is unnecessary. Given the GAAP requirements relating to other than temporary impairment, the capital position should reflect investments in which the initial investment is not expected to be recovered by way of the permanent impairment recognition process. Apart from that, any residual unrealized gains and losses are transitory by nature. With the passage of time, these instruments will return par given the intent and ability to hold to recovery. However, if the agencies conclude that some recognition of the AFS adjustment is required, we would agree with the suggested alternative as the lesser of two evils, classifying the portfolio into two categories: instruments whose value solely changes due to changes in the benchmark interest rate, and all others. The agencies should note however the diversification disincentive this creates relating to credit risk allocation within the investment portfolio. In the current environment, a range of institutions are struggling in their attempts to prudently achieve loan growth in their respective markets. As a result of this and the flattened yield curve, longer duration GSE products (debentures and MBS) have been utilized to combat compressing margins despite its resulting increased interest rate risk. However, in situations like this, one can make a strong argument for diversification into "credit" products (Corporate Debentures, CMBS, ABS, CLOs) instead of duration extension as a form of risk balancing (especially in light of reduced credit exposure within the loan portfolio – reduced loan portfolio size relative to total assets). This balancing of risks (credit, interest rate, liquidity, etc.) is essential to prudent balance sheet management. The requirement of the alternative to include unrealized gains/losses of "credit" products would clearly dilute the industry's ability to accomplish this goal efficiently.

Finally, in the event this route is taken, we would also ask for a much more explicit definition of what instruments are considered "debt securities whose valuations primarily change as a result of

fluctuations in a benchmark interest rate." The current definition given by the proposal provides a few examples:

1. U.S. government and agency debt obligations
2. U.S. GSE debt obligations
3. Other sovereign debt obligations that would qualify for a zero percent risk weight under the proposed standardized approach

We would argue that the definition (especially item 2 above) is too limited in scope. The term "U.S. GSE debt obligations" appears to focus solely on debentures and does not extend to GSE mortgage guaranty obligations. As such, we would ask for the agencies to extend the definition to include Agency MBS passthrough and CMOs, and SBA guaranteed pools. We would also argue that General Obligation Municipals and Essential Service (Water and Sewer) Revenue Obligations should fall under the scope of this alternative as well.

Cash Flow Hedge Adjustment

The proposal states that unrealized gains and losses on cash flow hedges that relate to the hedging items that are not recognized at fair value on the balance sheet (including projected cash flows) should be excluded from regulatory capital.[4] We would argue that this issue must be evaluated in light of the conclusion the agencies reach on the AFS inclusion item. As seen on the grid below, given the same hypothetical institution illustrated earlier, the utilization of cash flow hedge gains and losses can provide an efficient tool to mitigate the effects of the AFS portfolio on the capital position.

Swap Strategy Effects on CET1					
		Shocked Effects on the Tier 1 Common Equity Position Via Other Comprehensive Income			
	Existing Position	UP 100	UP 200	UP 300	UP 400
Swap Value		$2,258,384	$4,543,470	$6,478,692	$8,081,751
Swap Value (post tax)		$1,422,782	$2,862,386	$4,081,576	$5,091,503
Tier 1 Common Equity	$66,076,000	$67,498,782	$68,938,386	$70,157,576	$71,167,503
Change in Tier 1 Common Equity		$1,422,782	$2,862,386	$4,081,576	$5,091,503
CET1 Risk AFS Inv Portfolio		($6,008,726)	($14,016,212)	($23,169,164)	($30,892,219)
CET1 Protection Cash Flow Hedge		$1,422,782	$2,862,386	$4,081,576	$5,091,503
Offset Ratio (Loss in CET1 AFS vs. Cash Flow Hedge)		24%	20%	18%	16%
Resulting CET1 Ratio		8.09%	7.22%	6.18%	5.30%

The grid above demonstrates how a wholesale funding book composed of 3 Mo Libor borrowings which are synthetically fixed by using a pay fixed-receive 3 Mo Libor interest rate swap in a cash flow hedge designation ($45mm with approximately a 5 yr duration) could be instrumental in helping balance AFS portfolio's effects within the capital position.

The exclusion of cash flow hedges associated with hedged items that are not carried at fair value appears to have some logic given the following rationale. One could create a cash flow hedge relationship with an instrument not carried at fair value and a subsequent market move occurs in

[4] NPR Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequecy, Transition Provisions, and Prompt Corrective Action Pages 67-68

such a way that there is an unrealized gain on the swap (recognized in AOCI) and an unrealized loss on the hedged item (not reflected anywhere on the balance sheet). The inflated capital position due to the gain on the swap is not entirely accurate as the underlying hedged item's unrealized loss would have to be recognized as an offset assuming liquidation. Therefore, we would concur with the alternative provided that cash flow hedges created with short term instruments (less than a year to maturity) or floating instruments that allow for cancel of contract on any reset date as the hedged items should be allowed for inclusion within CET1. Again, this becomes increasingly important based upon the conclusion the agencies reach on the AFS portfolio inclusion issue.

Residential Mortgage Loans

The proposals currently create a set of criteria differentiating between Category 1 and 2 loans (with their respective LTV risk weight buckets).[5] There are two rather impactful and perhaps unintended consequences of the definition as written. The first item relates to the following requisite characteristic of a category 1 loan:

"The terms of the mortgage loan provide for regular periodic payments that do not:

a. Result in an increase of the principal balance
b. Allow the borrower to defer repayment of principal of the residential mortgage exposure
c. Result in a balloon payment"

This last item is particularly troublesome as certain institutions have a preponderance of residential mortgage loans that were originated with balloon payment features. However, these loan contracts did not have the other contractual terms listed in item a or b above. We question the applicability, in isolation, of this clause. It seems clear that the intent of this paragraph was to apply a more capital intensive charge to loans commonly referred to as option loans (e.g., Option ARMs). However, these loans exhibit most frequently all three of the characteristics cited above (or at least two of the three). Commonplace within the industry, residential loans exist that only exhibit the balloon payment portion and which are otherwise underwritten with standard loan terms. We would argue that the default/loss profile of these loans has been much lower over the crisis than the loans (e.g., Option ARMs) that appear to be the intent of this section.

As such, we would request a more explicit ruling that requires satisfaction of all three of the criteria (or at least two of the three) listed simultaneously in order to be disqualified as a Category 1 loan. However, if the agencies' conclusion is to leave this portion of the proposal unchanged, we ask for existing loans to be grandfathered as Category 1 and all new originations of balloon loans after implementation date be held to this new standard. This will allow for the industry to adjust structure or pricing effectively in light of the higher capital requirement.

The second noteworthy item within the residential mortgage loan proposals relates to periodic and lifetime caps. According to the NPR, a residential mortgage loan would be disqualified as a Category 1 loan if:
"The terms of the residential mortgage loan allow the annual rate of interest to increase no more than two percentage points in any twelve month period and no more than six percentage points over the life of the loan"

[5] NPR Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements Pages 28-34

Practically applying this definition within the HELOC market, as most all of the existing HELOC contracts were not written with either periodic or lifetime caps, results in an overwhelmingly immediate classification into the Category 2 bucket. Once again, we are not entirely sure that this was the intention of the rule (immediate punitive treatment of HELOC portfolios), we therefore ask for an exemption of HELOCs. However, if the agencies' conclusion is to leave this portion of the proposal unchanged, we ask for existing loans to be grandfathered and classified into Category 1 or 2 subject to the remaining components of the definitions (excluding this particular stipulation). Once again, this will allow for the industry to adjust structure or pricing effectively in light of the higher capital requirement.

Finally, the removal of the exception relating to the 120 day recourse programs on sold 1-4 family loans (liquidating into GSE programs) will have damaging effects on institutions with larger mortgage banking departments that routinely sell into secondary markets. We would ask the agencies to consider maintaining the current 120 day grace period exception so as to not disturb the pipeline of residential mortgage credit and the corresponding ancillary effects that would be felt in the housing market.

Non-Significant Investments in Unconsolidated Financial Institutions

The proposal puts forth the following ruling relating to non-significant investments in unconsolidated financial institutions:

"Under the proposal, if the aggregate amount of a banking organization's non-significant investments in the capital of unconsolidated financial institutions exceeds 10 percent of the sum of the banking organization's common equity tier 1 capital elements, minus certain applicable deductions and the other regulatory adjustments to common equity tier 1 capital (the 10 percent threshold for non-significant investments), the banking organization would have to deduct the amount of the non-significant investments that are above the 10 percent threshold for non-significant investments, applying the corresponding deduction approach."

We would first ask the agencies to provide clarity, specifically in defining which instruments would be subject to this ruling. As the proposal is currently written, we would interpret legacy investments in pooled trust preferred securitizations fall under its scope. However, we would argue that these legacy instruments should be treated instead under the scope of solely a securitization, rather than a capital investment in other financial institutions. Bearing in mind the preceding environment in which the majority of these instruments were purchased, (primarily 2004-2007), one can see the intention was to diversify within the investment portfolio at a time in which all other investment product spreads were compressing.

With that said, we ask for the agencies to consider these instruments as securitizations and treat them as such. We appreciate the intent of the ruling is to discourage direct capital investments within other financial institutions in order to avoid contagion risk. However, we see these instruments as legacy investments from a different time and environment, and therefore the holders of the instruments should not be unduly punished.

Simplified Supervisory Formula Approach

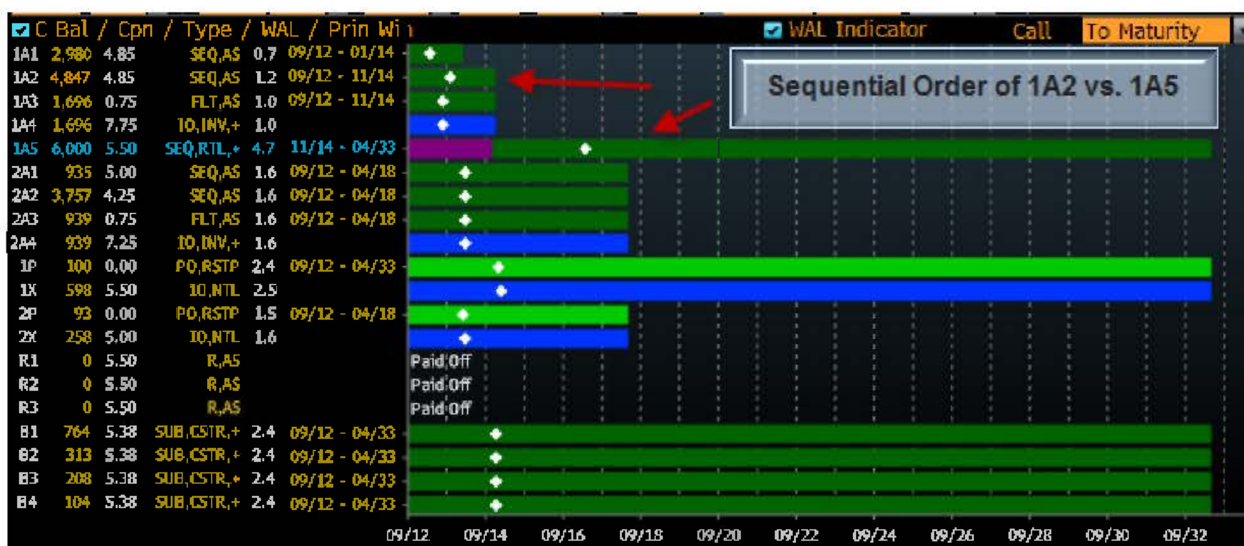
The NPR's revision of the SSFA is a vast improvement off its original version released within the last year. Below, we highlight three primary issues with the formula's construction:

1. Priority of Cash Flows – There are several instances in the universe of securitized deals in which the following simplified structure exists. There are 3 senior tranches within the deal that contain the same credit support/subordinate structure. Therefore, the senior deals are considered pari passu with one another and likely carry the same credit rating. However, as losses occur on the underlying pool of assets, the loss is applied to the subordinate tranche next in line but any recoveries (involuntary prepays) are allocated to the senior tranches within the deal. In the event that the senior tranches are structured as Sequentials (e.g., Tranche A receives all principal before Tranche B, which receives principal before Tranche C), Tranche A would receive the recovery amount thereby reducing its outstanding par. This implied credit support via the priority of cash flows structured within the deal is ignored by the SSFA in its current form.

   A good example of this would be the following bonds within the CDMC 2003-4 deal:

   CDMC 2003-4 1A2 Front Sequential CDMC 2003-4 1A5 Second Sequential

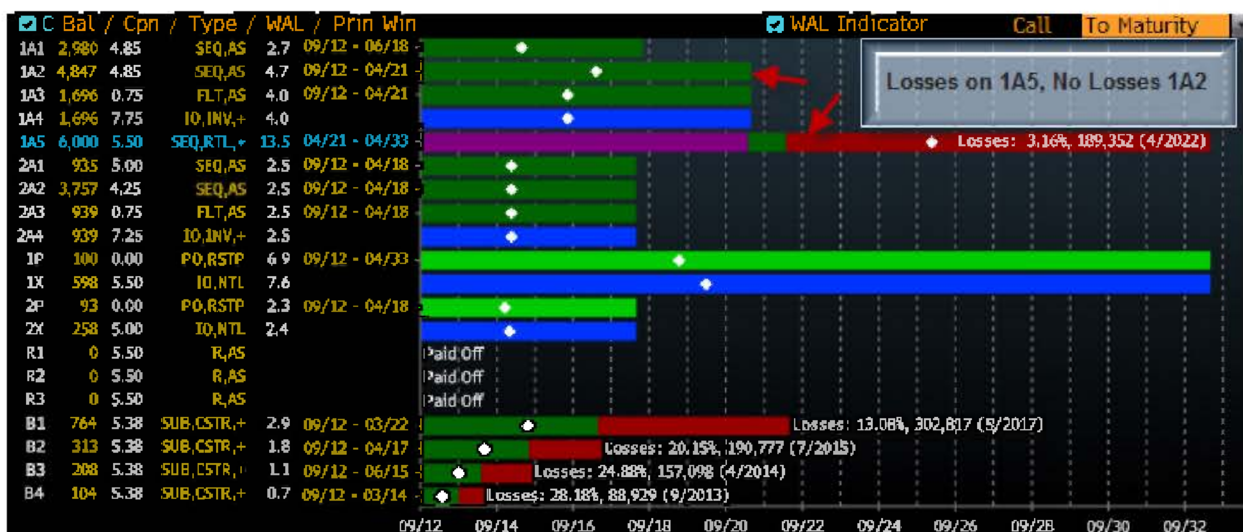
   The green bars above represent payment of principal while the purple illustrates interest payments. As these two bonds are pari passu senior within the deal structure, they have the same level of credit support (seen below).



Class	MDY	S&P	Fitch	DBRS	Original	Current	Coverage	7) CCvrge
1A1	-	AAA*-	AAA*-	-	2.300	6.964	3.835	0.952
1A2	-	AAA*-	AAA*-	-	2.300	6.964	3.835	0.952
1A3	-	AAA*-	AAA*-	-	2.300	6.964	3.835	0.952
1A5	-	AAA*-	AA*-	-	2.300	6.964	3.835	0.952

Current Credit Support of both tranches at 6.964%

However, as one stresses the cash flows with a set of default rate/loss severity/voluntary prepayment assumptions, you can see the priority of cash flow provides a level of protection to 1A2 (see below) not reflected within the credit support percentage alone.



We should also note that deal triggers add another level of complexity within the scheme of cash flow priority that is ignored by the SSFA in its current form.

2. Discounted Price – The effects of discounted price from par in the current market also acts as credit support feature (if one purchases a bond at $.85 and only incurs $.10 of principal loss of contractual par amount over its life, there was never impairment). The SSFA also ignores this factor. A good example of this would be ACE 2004-HE4 M1. Although this is a MEZ bond, it is now the "last loss" bond in the deal given the original senior tranches have paid off. The images below are from our Non-Agency RMBS Credit Profile created on March 13, 2012. In this analysis, our model attempts to isolate scenarios in which the credit support, excess interest, and discounted price were not sufficient to protect the bondholder from impairment.

Ticker	ACE 2004-HE4 M1		
Description	MEZ, FLT		
Collateral Type	Subprime Mixed 2004		
Class Type	MEZ		
Cusip	004421JH7		
Net Coupon	1.14 (1moLIB+60bps)		
WAM / WALA	267 / 91		
Factor	0.94900		
Current Mo. Ex Int.	390,715		
OC Target / Actual	6926399 / 0		
Orig / Curr Crdt Spprt	16.35 60.76		
Curr Trigger Status	P		
Coverage Ratio*	3.03x		
Ratings:	Mdy	S&P	Fitch
	Baa2/*-	AA+	N/A

Credit Support at time of analysis
60.76%

Offered price at time of analysis
$70.58

However, despite stressing the default and severity vectors provided by the model to extreme levels (indicated in the image below as the "nuclear" option), the principal writedown on the bond is not enough to impair the position.

Price/Yield Table

Price	Default Assump.	Interest Rate Scenario	1Yr CDR	LT CDR	Loss Sev	LT VPR	Cum Def
70.58	Optimistic	Rates Unchgd	4.78	6.01	78.0	8.3	34.64
70.58	Base Model	Rates Unchgd	5.86	7.23	88.0	3.4	48.06
70.58	Pessimistic	Rates Unchgd	6.91	8.36	96.5	1.5	56.56
70.58	Nuclear	Rates Unchgd	10.79	12.27	98.0	0.7	69.79

Cumulative Loss Projection (from Curr Bal)

Collat Loss %	Bond Loss %	Bond Loss Dlrs	1st Loss
27.00	0.00	0	No Loss
42.30	0.00	0	No Loss
54.60	5.23	2,304,043	Jul-23
68.39	26.54	11,689,625	Feb-19

Legend (Model Default/Severity/Prepayment Scenarios):

Optimistic: 100% of model CDR, 125% of model Loss Severity, 75% of model Vol CPR
Base Model: 125% of model CDR, 150% of model Loss Severity, 25% of model Vol CPR
Pessimistic: 150% of model CDR, 200% of model Loss Severity, 10% of model Vol CPR
Nuclear: 250% of model CDR, 225% of model Loss Severity, 5% of model Vol CPR

One can see that despite the "nuclear" stress position, the bond loss of 26.54% is not sufficient to impair the position at an acquisition price of $70.58.

3. <u>Re-securitizations</u> – The current version of the SSFA levers the effects of delinquencies within a re-securitization deal. The results are quite punitive. There are several examples we can provide of deals in which the senior tranche receives an excessive risk weight given the extreme adverse scenario required to break its subordinate structure.

We would also ask for clarification of certain sections within the definition of the SSFA:

a. W variable – the definition currently reads "the ratio of the sum of the dollar amounts of any underlying exposures within the securitized pool that are 'delinquent' to the ending balance, measured in dollars, of the underlying exposures". Does the term "securitized pool" denote the loan group or the credit group? Does the interpretation of the W variable and its application shift when subordinates remain relative to when the deal has gone pro-rata?

The deal CWALT 2004-18CB illustrates this issue as the deal is composed of five different loan groups sharing one set of subordinates (cross-collateralized). The 90+ delinquency for group 3 is currently 8.35% while 13.54% for all loan groups combined. Clearly, when these two values are assigned to the W variable, the formula will provide very different results.

b. Excess interest and Overcollateralization – should these two values be included within the attachment point percentage?

We appreciate the mandate to move from credit ratings due to complying with Dodd-Frank. Additionally, we understand the need to create a standard formula for uniform application across the industry. However, we must put forth that the most appropriate method to assess this issue would be to apply dynamic cash flow modeling. In essence, each securitization within the portfolio would be stressed across a range of <u>adverse</u> scenarios to determine the structures' susceptibility to any credit levered features within each deal. We realize that this does not necessarily allow for uniformity (unless you adopt a similar model as that of the insurance industry by having one primary provider for third party pricing/valuations for each bond in the market) and that it is a very assumption driven approach. However, we would argue that for this cash flow

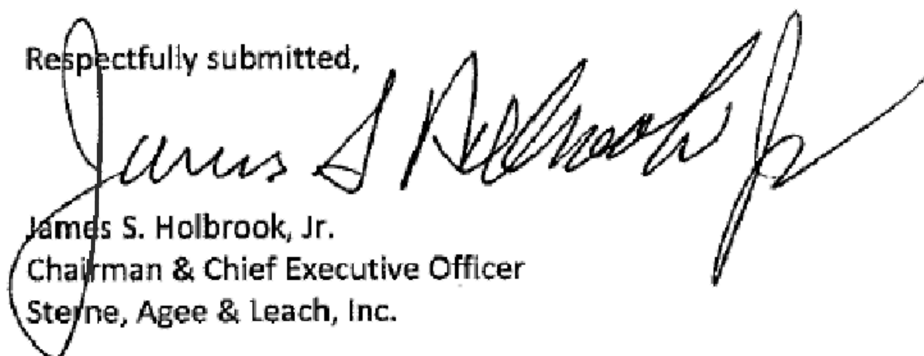
modeling/assumption driven approach, each institution would have to stand ready to illustrate its assumptions and defend them properly. This will be the only way to satisfactorily address the three items above.

Finally, we would add that this approach differs from the current GAAP impairment model framework whose focus is to find the most likely estimate of future cash flows. In this approach, given that risk weights are designed to capture potential adverse scenario effects on assets and their implications on capital, the approach would highlight a range of adverse scenarios and the corresponding assets performance (or underperformance if appropriate) and create an appropriate risk weight accordingly.

Conclusion

Once again, we are grateful for the opportunity to comment on the proposals as presented and look forward to working with the agencies and industry to find a palatable solution. Below, please find the institutions that have co-signed this comment letter. If there are any questions or requests for more information, please contact us at the numbers below.

Respectfully submitted,



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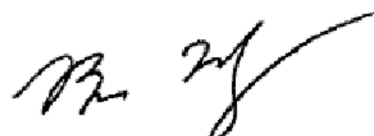

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