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THE CLEARING HOUSE
Advancing Payment Solutions Worldwide

July 9, 2004

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Attention: Jennifer J. Johnson, Secretary

Re: Notice of Proposed Rulemaking Concerning Trust Preferred Securities and Related Matters – Docket No. R-1193

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("The Clearing House"), an association of major commercial banks,[1] appreciates the opportunity to comment on the notice of proposed rulemaking ("NPR") of the Board of Governors of the Federal Reserve System (the "Board") regarding the tier 1 capital treatment of trust preferred securities and related matters.

We commend the Board for its sensible and balanced analysis of the contribution of trust preferred securities as a component of tier 1 capital and its decision to preserve trust preferred securities as tier 1 capital. We support the Board's evaluation of trust preferred securities as not only a tax-efficient source of tier 1 capital, but as relatively simple, standard and well-understood instruments that are also issued by non-banking corporations. Since the implications of the Financial Accounting Standards Board's ("FASB") Interpretation No. 46 (as

1 The members of The Clearing House are Bank of America National Association, The Bank of New York, Citibank, N.A., Deutsche Bank Trust Company Americas, HSBC Bank USA, National Association, JPMorgan Chase Bank, LaSalle Bank National Association, U.S. Bank National Association, Wachovia Bank, National Association, and Wells Fargo Bank, National Association.

Deutsche Bank Trust Company Americas and LaSalle Bank National Association are subsidiaries of foreign banks that, for Bank Holding Company Act purposes, are financial holding companies. Under a January 5, 2001 supervisory letter of the Division of Banking Supervision and Regulation (SR 01-1), their intermediate U.S. holding companies are not required to comply with the Board's capital adequacy guidelines. Accordingly, these banks are not participating in this letter insofar as it relates to bank holding company capital.

revised, "FIN 46R") on the tier 1 eligibility of trust preferred securities first became apparent, The Clearing House as an organization and our members individually have expressed views that are consistent with the rationales outlined in the NPR for the continued inclusion of trust preferred securities in tier 1 capital.

As to the stricter quantitative limits and qualitative standards proposed in the NPR for trust preferred securities and other capital components, we are not concerned with the proposed change in qualitative standards – the key one being that the underlying junior subordinated debt in a trust preferred securities offering must comply with the standards applicable to subordinated debt that qualifies as tier 2 capital, except that acceleration will be permitted upon default in payment of interest at the end of the five-year interest deferral period. However, we are very concerned with the stricter quantitative limits that are proposed. The combination of the deduction of goodwill from the core capital components against which the applicable limit is applied, together with a 15% limit (whether mandatory or implied), would have a significant effect on our members and on many other U.S. banking institutions – particularly those participating in the on-going consolidation of the U.S. banking industry – due to the goodwill arising under purchase accounting.

We have set forth in Part I our views with respect to the proposed changes in quantitative limits and in Part II certain other comments on the NPR.

I. <u>Quantitative Limits</u>

The NPR creates a new definition of "restricted core capital elements" that includes trust preferred securities, cumulative perpetual preferred stock and certain minority interests (*i.e.*, the new definitions of "Class B minority interests" and "Class C minority interests"). The NPR then goes on to propose two new fundamental and inter-related quantitative limits on restricted core capital elements. First, the NPR proposes that goodwill be *subtracted* from the base of core capital elements against which the percentage limit on restricted core capital element is applied where, heretofore, goodwill has not been subtracted from total core capital elements for this purpose. Second, the NPR proposes that the risk-based capital guidelines recite that the Federal Reserve "generally expects internationally active banking organizations to limit" restricted core capital elements included in tier 1 to 15% of core capital elements, net of goodwill. The NPR describes this as a formalization of the Board's commitment to the G-10 banking supervisors to use "best efforts to limit the issuance by internationally active banking organizations of innovative instruments" to 15% of core capital elements, net of goodwill.

The combined effect of these new quantitative limits on many of the banking organizations that become subject to them will be significant. If the NPR's proposal with respect to the deduction of goodwill were adopted and the nine bank holding companies expected to be required to use the advanced internal ratings based approach (or "A-IRB") under BIS II[2] were required to apply a 15% instead of 25% limit (whether as an absolute requirement or in response to the Board's expectation), their capacity for issuance of trust preferred securities and other restricted core capital elements would decline by 61% (from $103.3 billion using a 25% limit and not subtracting goodwill to $40.6 billion using a 15% limit and subtracting goodwill). These bank holding companies effectively would be precluded from raising additional tax-advantaged tier 1 capital for the foreseeable future. See Annex 1 attached hereto. We strongly urge the Board to reconsider these aspects of the NPR.

(i) Deduction of Goodwill

First, it is important to recognize that the adverse practical consequences of this proposal will continue to increase. This results from the interplay of three factors – (i) the change in 2001 in the accounting for business combinations, (ii) the fact that the U.S. banking market continues to be consolidating and certain banking organizations are expanding the scope of their operations through acquisitions, and (iii) the fact that the value of banking organizations is normally considerably greater than book value, resulting in the recognition of sizable amounts of goodwill from these acquisitions.

Prior to 2001, a requirement that goodwill be subtracted from the core capital base in establishing a limit on restricted capital components would have had a meaningful impact on few if any U.S. bank holding companies. The reason, of course, is that virtually all major acquisitions were accounted for as poolings, not purchases. In July 2001, the FASB issued Statement No. 141, *Business Combinations*, and Statement No. 142, *Goodwill and Other Intangible Assets*. Taken together, they generally require that all business combinations initiated after June 30, 2001 be accounted for under the purchase method of accounting, and that goodwill no longer be amortized against earnings but instead be reviewed periodically for impairment.

Consolidation in the U.S. banking industry, which had slowed in 2001 and 2002 with the generally weak economy and securities markets, picked up substantially in the last

2 Based on the proposed standard of $250 billion or more of total banking assets or $10 billion or more of total on-balance-sheet foreign exposure, we understand that these bank holding companies are Citigroup, Inc., J.P. Morgan Chase & Co., Bank of America Corporation, Wells Fargo & Company, Wachovia Corporation, Bank One Corporation, FleetBoston Financial Corporation, The Bank of New York Company, Inc. and State Street Corporation. Based on information in their Form FR-Y9C's for December 31, 2003, at that date these nine bank holding companies in the aggregate had total goodwill of $80 billion and total core capital elements of $348.4 billion. Four of these bank holding companies are in the process of combining – J.P. Morgan Chase & Co. with Bank One Corporation and Bank of America Corporation with FleetBoston Financial Corporation. We have not attempted to adjust the data in Annex 1, which is based on information in the Form FRY-9C report as of December 31, 2003, for those subsequent events.

quarter of 2003. The aggregate dollar values of U.S. bank mergers announced during 2002 and the first nine months of 2003 were $17.6 billion and $14.9 billion, respectively. The aggregate dollar values of U.S. bank mergers announced during the last quarter of 2003 and the first quarter of 2004 were $57.4 billion and $82.4 billion, respectively.[3] The competitive effect of the stricter quantitative standards for U.S. banking organizations as compared to their European counterparts is particularly important as the U.S. banking industry resumes what is generally expected to be a period of substantial consolidation. Apart from the numeric impact apparent from these numbers, the loss of goodwill as an element of the base for calculating the permissible level of trust preferred securities threatens to exacerbate what appears to us to be the competitive disadvantage for U.S. banking organizations in that certain European banks have been permitted to reduce their capital level to a greater extent in cash transactions than U.S. banks.

Second, the requirement that goodwill be deducted from core capital elements presumably rests on the assumption that goodwill is substantially lacking in value. We believe that assumption is incorrect. The periodic impairment testing requirement under FASB Statement No. 142 acts as an important governor on the amount of goodwill recorded on the balance sheet. Additionally, one argument that has been made for the total discount of goodwill is that it has no value in an insolvency. We believe that premise is incorrect. Banks that are in serious financial difficulty are often sold before a receivership occurs. Even after receivership, bank level deposits can normally be sold at a premium – there is value to the deposit relationships in all cases.

Third, in explaining the goodwill proposal, the NPR states that "it will help insure that a BHC is not unduly leveraging its tangible equity to issue restricted core capital elements." We are not aware of any factual support for the conclusion that any large U.S. bank holding company has issued excessive amounts of restricted core capital elements. Market discipline, and the Federal Reserve's regulatory oversight and discretion in evaluating capital adequacy, have acted to preclude that result. If the Board's concern is that some community banks have over-relied upon trust preferred securities as a tier 1 capital component, we urge the Board to address that concern directly in its oversight of those institutions and not with a requirement that goodwill be deducted from core capital components for all banking organizations. Moreover, because community banks in most cases are not likely to have proportionately large amounts of goodwill on their balance sheets, the deduction of goodwill as proposed by the NPR is not likely to be a meaningful component of addressing any perceived over-reliance by such banks.

Fourth, the risk-based capital guidelines already include a provision protecting against over-reliance on goodwill –the requirement that goodwill be deducted from the sum of core capital components to determine tier 1 capital.

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[3] These numbers do not include the dollar value of U.S. bank holding company and bank acquisitions of non-banks – clearing and processing businesses, for example.

Fifth, if the Board nevertheless requires that goodwill be subtracted from the base of core capital elements against which the percentage limit on restricted core capital elements is applied, we believe that any deduction of goodwill for this purpose should be on a "net of tax" basis. Such an approach would recognize the absolute minimum economic value of goodwill, as well as be consistent with regulatory precedent for similar situations.[4] Alternatively, we believe 50% of goodwill should be deducted from each of tier 1 capital and tier 2 capital for these purposes.

(ii) 15% Versus 25%

The NPR states that the purpose of the proposal is "to help insure comparability in capital structures among internationally active banking organizations." We do not believe that the goal of comparability, which is a highly subjective and multifaceted issue, should overrule what is the appropriate approach. For U.S. bank holding companies, disclosure required by the Federal securities laws, combined with the market discipline from that disclosure, removes any obstacle for investors in analyzing strength of capital. Insofar as regulatory supervision and oversight is concerned, as mentioned above, we expect the Federal Reserve will continue to exercise its discretion on a case-by-case basis in evaluating the adequacy of capital.

(iii) Phase-In Period

If the Board nevertheless determines to proceed with the proposed new quantitative limits, The Clearing House urges the Board to adopt a five-year instead of a three-year transition period. A significant volume of bank holding company trust preferred securities has been issued since July 1, 2002, with no-call periods of at least five years (meaning the no-call periods expire at various dates after July 1, 2007). Additionally, a significant volume of the early bank holding company trust preferred securities offerings, particularly in 1996 and 1997, were sold to institutional investors, with no-call periods of ten years and declining redemption premiums in years 11 through 20. A five-year transition period would give affected bank holding companies substantially more flexibility to manage their compliance with any new standards through a combination of redemption of trust preferred securities whose no-call periods have expired or redemption premiums have declined and internal capital generation.

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4 On April 11, 2002, The Clearing House submitted a letter to the Board, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the Office of Thrift Supervision, making the case that goodwill should not be deducted from the sum of core capital components to determine tier 1 capital but, if it is deducted, the deduction in any event should be on a "net of tax" basis. See pages 4-5 of that letter, a copy of which is enclosed.

(iv) Internationally Active Banking Organizations

Whatever standards the Board ultimately adopts, we very strongly believe that, with perhaps one exception, they should apply to all U.S. banking organizations in the same way. We do not believe that a distinction should be drawn between internationally active banking organizations, however defined, and other banking organizations. There are a number of large and very competitive U.S. banking organizations that would not fall within any likely definition of "internationally active". We can foresee no reason for giving them greater access to tax-advantaged capital instruments or other restricted core capital elements than those that are deemed to be internationally active. Doing so would be a major competitive concern for our members.

If an exception were to be made, we believe the exception should key off of access to capital markets, not whether the excepted banking organization is internationally active. If the Board proceeds with a 15% limit, the only exception we would support would be an exception for community banks with limited access to capital markets.

* * *

We understand, of course, that these proposals derive in part from international developments – (i) in the case of the deduction of goodwill from the basic core capital elements, the proposal in the BIS's April 2003 Consultative Document that limits innovative tier 1 instruments based on the amount of core capital after deduction of goodwill, and (ii) in the case of the 15% (as opposed to 25%) standard, the BIS's 1998 press release concerning innovative capital instruments and the aforementioned agreement among G-10 banking supervisors. We nevertheless think that approach is wrong – both for U.S. bank holding companies and likely for non-U.S. banking organizations. Moreover, there is no direct comparability. For example, the BIS's concept of innovative capital instruments, which is not defined, likely is not the same as the NPR's proposed definition of restricted core capital elements. If the BIS proceeds with its standards, we urge the Federal Reserve and other regulators to address the comparability issue through disclosure. Provided that the aggregate amount of core capital elements and goodwill are set forth in a financial institution's disclosure, investors and other users of financial statements and related disclosure, including regulators, will be able to compare capital on an equivalent basis.

II. Other Comments

(i) Moderate Step-Ups

The NPR proposes to expressly include in the Board's risk-based capital guidelines the Board's long-standing view that a dividend rate step-up, however moderate, generally disqualifies the instrument from inclusion in tier 1 capital. We urge the Board to revisit this issue and consider permitting moderate step-ups that satisfy the criteria in the BIS's October 1998 interpretation concerning innovative capital instruments.[5] The pricing benefit from permitting moderate step-ups, and the related reduction in cost of capital for the U.S. banking industry were moderate step-ups permitted, is significant.

The challenge, of course, is to determine whether the permitted step-up is sufficiently moderate that it does not create an economic compulsion to redeem (effectively turning the instrument into a term instrument and, accordingly, definitionally an instrument that is not tier 1 capital) but, at the same time, creates a sufficient likelihood of redemption at the step-up date (which is also the end of the no-call period) so that investors are willing to "pay" for that expectation. BIS-permitted moderate step-ups have become virtually universal in European bank innovative tier 1 capital transactions. We do not believe moderate step-ups of the type permitted by the BIS create an economic compulsion to redeem. Moreover, the instrument in any event could not be redeemed without prior Federal Reserve approval.

(ii) Trust Preferred Securities "Without the Trust"

We urge the Board to consider permitting tier 1 capital treatment for direct issuances of junior subordinated deferrable 30-year debt of the type owned by the issuing trusts in trust preferred securities transactions (the "junior sub debt"), without requiring that the junior sub debt be "wrapped" in a trust. Economically and substantively, the issuing bank holding company and investors would be in identical positions if the trust were eliminated.

When trust preferred securities (and their immediate predecessors using limited liability companies and Turks and Caicos corporations) were first developed as a product for industrials and insurance companies in the mid-1990s (before the Federal Reserve recognized trust preferred securities as a tier 1 capital component), the only reason for inserting a trust or

5 The BIS interpretation permits a step-up in conjunction with a call option only if the step-up occurs at least ten years after the issue date and if it results in an increase over the initial rate that is no greater than (i) 100 basis points, less the swap spread between the initial index basis and the stepped-up index basis, or (ii) 50% of the initial credit spread, less the swap spread between the initial index basis and the stepped-up index basis. Because of the current low interest rate environment, virtually all securities issued in recent years using the BIS step-up formulas have relied on the formula in clause (i).

other vehicle between investors and the underlying junior subordinated debt was to create an instrument that, in the hands of investors, was labelled equity. At that time the rating agencies gave more equity credit for an instrument that was labelled equity as opposed to debt because of their perception that the underlying issuer on the junior subordinated debt would be more inclined to exercise its right to defer interest in a time of financial distress if the instrument held by the public were labelled equity. We believe the rating agencies have, over the years, substantially abandoned any distinction between a direct issuance of junior subordinated debt, on the one hand, and trust preferred securities that are economically identical, on the other hand. We urge the Board to do the same, particularly now that under FIN 46R the consolidated balance sheet treatment of trust preferred securities is to record the underlying junior subordinated debt as a liability instead of to record the trust preferred securities as a minority interest. Investors fully understand that the trust in a trust preferred securities transaction is a pass-through entity and that economically they own the underlying junior subordinated debt. We do not believe bank holding companies would be more reluctant to exercise their deferral rights on junior subordinated debt issued directly to investors than on junior subordinated debt owned by a trust that issued trust preferred securities to investors. At this point, there does not seem to be any sound reason for forcing bank holding companies to incur the additional expense and deal with the additional complexity of requiring that a trust be interposed between investors and the underlying junior subordinated debt.

(iii) <u>Balance Sheet Classification on Form FR-Y9C</u>

Bank holding companies currently report the underlying junior subordinated debt in trust preferred securities offerings as “other liabilities” on Schedule HC of the Form FR-Y9C. We believe it would be more appropriate, and more consistent with the current GAAP balance sheet presentation required by FIN 46R, to classify this item as subordinated debt. If the intent is not to commingle the underlying subordinated debt in trust preferred securities transaction with all other subordinated debt, then we strongly urge the Board to create a separate line item in Schedule HC for junior subordinated debt issued to trusts in these transactions. This will not only facilitate reconciliation of total subordinated debt disclosed in public financial statements to the amounts disclosed in regulatory reports, but also lead to greater transparency.

* * *

Thank you for considering the views expressed in this letter. If you have any questions, please contact Norman R. Nelson, General Counsel of The Clearing House, at 212-612-9205.

Sincerely yours,

Annex 1

Peer Data
Proposed Trust Preferred Securities Impact
December 31, 2003

Dollars in millions

		Goodwill	Total Equity Capital	Backout Fax 115 and 133	Total Qualifying Capital	Qualifying Minority Interests	Total Core Capital Elements	Qualifying Minority Interests as a Percentage of Core Capital Elements	Qualifying Minority Interests as a Percentage of Core Capital Elements Less Goodwill	Total Capacity to Issue Trust Preferreds Under the Existing Method (a)	Remaining Capacity to Issue Trust Preferreds Under the Existing Method	Total Capacity to Issue Trust Preferreds Under the Proposed Method (b)	Remaining Capacity to Issue Trust Preferreds Under the Proposed Method
		HC line 10a	HC-R line 1	HC-R lines 2 & 4	B + C	HC-R line 6	D + E	E / F	E / (F -A)	D x (25%/75%)	G - E	(D-A) x (15%/85%)	H - E
		A	B	C	D	E	F			G		H	
1	Citigroup, Inc.	27,581	98,014	(3,659)	94,355	7,415	101,770	7.3%	10.0%	31,452	24,037	11,784	4,369
2	JPMorgan Chase & Co.	8,511	46,154	24	46,130	6,881	53,011	13.0%	15.5%	15,377	8,496	6,639	(242)
3	Bank of America Corp.	11,455	47,980	1,877	49,857	6,183	56,040	11.0%	13.9%	16,619	10,436	6,777	594
4	Wachovia Corp.	11,149	32,428	(1,336)	31,092	4,819	35,911	13.4%	19.5%	10,364	5,545	3,519	(1,300)
5	Wells Fargo and Co.	10,371	34,469	(926)	33,543	3,833	37,376	10.3%	14.2%	11,181	7,348	4,089	256
6	Bank One Corp.	2,061	23,419	(160)	23,259	3,785	27,044	14.0%	15.2%	7,753	3,968	3,741	(44)
7	FleetBoston Financial Corp.	4,273	18,280	(476)	17,804	3,294	21,098	15.6%	19.6%	5,935	2,641	2,388	(906)
8	The Bank of New York Co. Inc.	3,275	8,428	(125)	8,303	1,150	9,453	12.2%	18.6%	2,768	1,618	887	(263)
9	State Street Corp.	1,326	5,748	(74)	5,674	1,000	6,674	15.0%	18.7%	1,891	891	767	(233)
	Totals	80,002	314,920	(4,855)	310,017	38,360	348,377	11.0%	14.3%	103,339	64,979	40,591	2,231

Notes
Data was extracted from the 12/31/03 FR Y-9C reports - Schedules HC and HC-R
Assume all qualifying minority is Class C minority interest and is restricted core capital

(a) Existing method - Qualifying minority interests are limited to 25% of qualifying capital. To determine the amount of qualifying minority interest, multiply the amount of qualifying capital by 33.33%.
The number is derived from the proportion of 25% to 75% (I.e. 25%/75% = 33.33%).

(b) Proposed method - Qualifying minority interests will be limited to 15% of qualifying capital, net of goodwill. To determine the amount of qualifying minority interest, multiply the amount of qualifying capital, net of goodwill by 17.65%.
The number is derived from the proportion of 15% to 85% (I.e. 15%/85% = 17.65%).

NEW YORK CLEARING HOUSE

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JEFFREY P. NEUBERT
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April 11, 2002

Alan Greenspan, Chairman
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Federal Deposit Insurance Corporation
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Mr. James Gilleran
Director
Office of Thrift Supervision
1700 G Street, N.W.
Washington, D.C. 20429

Re: Treatment of Goodwill for Regulatory Capital Purposes

Dear Sirs:

The New York Clearing House Association L.L.C. (the "Clearing House") is writing to the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (the "Agencies") to request a revision of the regulatory capital treatment of the goodwill assets of banking organizations.* We believe that a continuation of the dollar-for-dollar reduction of Tier 1 capital in respect of goodwill is inconsistent with both economic logic and recognized accounting standards. Moreover, the recent revision of the accounting standards for business combinations makes a revision imperative to avoid significant competitive disadvantage for banking organizations.

After lengthy deliberations involving substantial input from both the public and private sectors, the Financial Accounting Standards Board ("FASB") has significantly revised the accounting standards for business combinations. Although much of the attention was devoted to FASB's decision to eliminate pooling of interests accounting, the arguably more important decision was to eliminate the requirement of automatic amortization of goodwill pursuant to a pre-determined schedule. FASB recognized that goodwill can have meaningful and measurable economic value and, accordingly, as of December 15, 2001, goodwill will remain as an asset under generally accepted accounting principles unless, until and to the extent it becomes impaired.

Under this new standard, a banking organization (or any other company) is obligated to conduct periodic (at least annual) evaluations of the goodwill asset and reduce its value when the fair value has declined below the original estimated value. A series of tests is prescribed to determine fair value. In addition, if various events occur that reduce the value, there must be an immediate reduction. This process is audited by the company's independent certified public accountants.

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* The member banks of the Clearing House are: Bank of America, National Association, The Bank of New York, Bank One, National Association, Bankers Trust Company, Citibank, N.A., Fleet National Bank, HSBC Bank USA, JPMorgan Chase Bank, LaSalle Bank National Association, Wachovia Bank, National Association and Wells Fargo Bank National Association.

The FASB decision on goodwill is consistent with economic logic. A banking organization (or any other company) would pay more than the book value of an acquired company or an acquired business only if it believed that the economic value of the acquired company or business exceeded its book value. More specifically, the price paid would not exceed the value the acquiring company places on the acquired business or company after taking into account, among other things, the risks inherent in the acquisition.

We appreciate that the Agencies may be concerned that the anticipated economic value of goodwill may not be realized. That, however, cannot be the relevant criterion for a dollar-for-dollar capital reduction, because such a criterion is applicable to a number of 100% risk-weighted assets. For example, every time a bank makes a loan, it presumably anticipates that the principal will be paid in full. Yet, a meaningful number of loans are not paid at maturity.

A particular concern has been expressed by the Agencies that the value of goodwill would be lost upon an institution's insolvency. The record of sales of depository institutions by the FDIC, however, demonstrates that even an insolvent institution often has a value greater than its net asset value.

The fallacy of requiring an immediate 100% write-off of goodwill is illustrated by the acquisition of a trust operation, which has no or minimal net asset value. Because the fee income from that trust operation represents ascertainable economic value, the acquisition price will reflect that economic value. That price will all (or virtually all) be booked as goodwill. Yet, the current capital rules, by requiring a dollar-for-dollar goodwill deduction, deny any economic value.

There is also a statutory basis for the Agencies to take into account this economic value as now recognized by the FASB. Section 121 of the Federal Deposit Insurance Corporation Improvement Act (12 U.S.C. §1831(n)) provides that the accounting principles applicable to reports or statements required to be filed with Federal banking agencies by insured depository institutions shall be uniform and consistent with generally accepted accounting principles.

If the Agencies believe that the goodwill is a riskier (i.e., less predictable) asset than other assets, then we respectfully submit that the appropriate response is not to value the asset at zero, but rather to increase the risk-weighting to at least 500%. Such a response would be more consistent with the Agencies' basic approach of calibrating risk and capital more precisely in place of a blunderbuss approach.

If the Agencies are not prepared to alter the dollar-for-dollar approach, we believe that any deduction of goodwill from capital should be on a "net of tax" basis. Such an approach would recognize the absolute minimum economic value of goodwill, as well as be consistent with regulatory precedent for similar situations.

When the risk-based capital regime was originally adopted, goodwill was never deductible for tax purposes. Since that time, however, the tax code has been amended so that goodwill is deductible if the goodwill arises from an asset acquisition or a transaction treated as an asset acquisition for tax purposes.

This tax deduction has significant and readily calculable benefits. It will increase cash flow throughout the tax amortization period in the amount of the annual deduction. This benefit is achieved irrespective of the ultimate value of the goodwill for book reporting purposes.

The following example may be helpful in illustrating this tax benefit. Assume that the goodwill arising in a taxable transaction is 120x. Typically, this goodwill will be amortized for tax purposes over 15 years, or 8x per year. At a 40% combined tax rate, the tax benefit in each year would be 3.2x, and over the 15-year period would be 48x. Subtracting 48x from 120x would reduce the goodwill deduction from regulatory capital to 72x. Because, however, the accounting rules require companies to record a deferred tax liability for this benefit of 48x, the current methodology for calculating capital ratios would never reflect the benefit of the cash generated through the tax deduction.

The only possible constraint on the value of the tax benefit would be if the company does not have sufficient taxable income to utilize the tax credit. The potential of this occurring is, however, minimized by the carryback (two years) and carryforward (20 years) provisions, i.e., tax deductions not usable in a given year can be credited against taxable income for the two prior years or the 20 subsequent years. As a further safeguard, the net of tax approach to the goodwill deduction from regulatory capital could be further limited by providing that the annual tax benefits not exceed 50% of average net income for the last three years.

Even if one were to utilize a theoretical “worst case” analysis and assume that the banking organization never again had any earnings, the tax benefit of the goodwill still has value. This value is equal to the amount of tax benefits that could be realized through the carryback formulation. Under what we believe is an extraordinarily conservative approach, the goodwill deduction from regulatory capital should, at the barest minimum, be reduced by the carryback value of the related tax benefit.

A similar approach is appropriate even for acquisitions where the goodwill is not deductible for tax purposes. In such cases, companies record a deferred tax liability for all intangible assets other than goodwill. Assume that the core deposit intangible assets recorded in a non-taxable transaction is 100x. A deferred tax liability will also be recorded of 40x with an offsetting increase to goodwill of 40x. As the 100x intangible asset is amortized to expense, the deferred tax liability will be amortized to income, resulting in a net earnings charge of 60x over the life of the asset. However, the current rules result in a 100x reduction of Tier I capital at the time of the acquisition, representing the 100x of the intangible asset and the 40x of incremental goodwill, reduced by the 40x of deferred tax liability.

A decision by the Agencies to utilize our recommended net after tax approach would be consistent with the Agencies regulatory approach in two comparable situations. First, the regulatory capital deduction required for “excess” mortgage servicing rights is made on an after tax basis. 12 C.F.R. §325.5(f). Second, the Agencies’ recently adopted rules requiring deduction of certain residual interests from regulatory capital provide for the deduction to be made on an after tax basis. Id.

In considering this issue, we submit that an important consideration is the competitive position of the banking industry. In an environment in which the financial services industry continues to consolidate at a rapid pace, it is essential that banking organizations not be placed at a competitive disadvantage with their nonbank competitors in making acquisitions. The need for such a level playing field has been made even more pressing by the Gramm-Leach-Bliley Act.

Banking organizations must manage their capital position to satisfy both the market (investors and rating agencies) and the Agencies' regulatory capital requirements, whereas nonbank financial institutions must generally manage their capital only to satisfy the market. To the extent that the regulatory capital requirements exceed the market's requirements, banking organizations are placed at a competitive disadvantage.

As the Clearing House has previously communicated with the Agencies on a number of occasions, we believe that the current regulatory capital requirements already create a competitive disparity because they are not sufficiently calibrated to measure actual economic risk. In a purchase accounting environment, a regulatory capital deduction for goodwill that is inconsistent with its economic value would seriously exacerbate this existing disparity.

In conclusion, we respectfully submit that the treatment of goodwill for regulatory capital purposes deserves the Agencies' most immediate attention. When a substantial majority of banking organizations' acquisitions, in terms of the consideration paid, were accounted for on a pooling basis, the limited discrepancy between the economic value of goodwill and regulatory capital value could be accepted. Because this discrepancy became universal when pooling accounting ended on June 30, 2001, its existence has profoundly affected the U.S. banking industry and its competitive position.

We appreciate your consideration of this request, and we would appreciate the opportunity to meet with the Agencies to discuss the issue further. Please feel free to call Norman

Nelson, General Counsel of the Clearing House, at (212) 612-9205, with any questions or if you believe that it would be useful to have a meeting.

Very truly yours,