DISCOVER
FINANCIAL SERVICES

October 15, 2009

Office of the Comptroller of the Currency
250 E Street, SW
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Washington, DC 20219

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman, Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn: OTS-2009-0015

RE: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues

OCC: Docket ID: OCC-2009-0012
Federal Reserve System: Docket No. R-1368
Federal Deposit Insurance Corporation: RIN 3064-AD48
OTS: OTS-2009-0015

Ladies and Gentlemen:

Discover Financial Services appreciates the opportunity to comment on the agencies' notice of proposed rulemaking on the topics referenced above. As one of the nation's largest issuers of consumer credit cards, Discover is vitally interested in the impact of the Financial Accounting Standard Board's Statement of Financial Accounting Standards No. 166 *Accounting for Transfers of Financial Assets-an amendment of FASB Statement No. 140*, and Statement of Financial Accounting Standards No. 167 *Amendments to FASB Interpretation No. 46(R)*, (collectively "FAS 166/167") on regulatory capital.

Discover believes that unless changes are made to existing risk-based capital rules, FAS 166/167 will have significant adverse consequences for consumer lending and the U.S. economy as a whole. As the rules are currently written, FAS 166/167 will have an immediate and significant adverse impact to many lending institutions' capital levels and ratios under the regulatory capital rules. In order to maintain adequate capital positions, these lending institutions, which provide critical financing to consumers, small businesses, corporations, etc., will either have to raise additional capital, reduce lending activities or both. We believe that the net effect from this will be an increase in the cost and decrease in the availability of credit to both consumers and corporate borrowers. We believe that the adoption of FAS 166/167, without any transition period or any adjustment to existing regulatory capital rules, will cause a further reduction to credit availability which will impair the economic recovery and prolong the U.S. economic downturn.

Summary

The new accounting standards will have an immediate and significant impact on banking institutions' capital ratios. Without modification to existing risk-based capital rules, the negative impact of FAS 166/167 results from an increase in risk-weighted assets as loans that are currently off-balance sheet are reconsolidated (i.e., the "denominator" effect) and a decrease in equity capital as loan loss reserves are posted for the reconsolidated assets (i.e., the "numerator" effect). In addition, many institutions will also be negatively impacted by limits on the amount of loan loss reserves that can be counted for capital purposes and the amount of deferred tax assets ("DTAs") that may potentially be disallowed.

In summary, **Discover believes that the agencies should make the following permanent revisions to the regulatory capital rules:**

- Increase or eliminate the current cap on the amount of allowance for loan losses that is eligible to qualify as Tier 2 capital.

- Modify the limitation on deferred tax assets that qualify as regulatory capital such that capital regulations would simply follow U.S. GAAP in their treatment of deferred tax assets.

Discover also believes that the agencies should adopt a phase-in period for both the "numerator effect" as well as the "denominator effect" that corresponds with the average remaining life of the securitization transactions currently outstanding, or for simplicity, a period of three to five years. A phase-in period should not be viewed as an alternative to the proposed permanent changes to the treatment of allowance for loan losses and deferred tax assets under the risk-based capital rules.

Each of these is discussed below and corresponds to notice of proposed rulemaking questions 3, 4 and 10. In addition, Discover has participated in industry group comments to the notice of proposed rulemaking and is supportive of the comments submitted by the American Bankers Association and American Securitization Forum.

1. <u>Adjusting Amount of Allowance for Loan Loss Eligible for Tier 2 Capital</u>

Under risk-based capital rules, consolidation of off-balance sheet securitization trusts under FAS 166/167 will result in banking institutions having to hold regulatory capital against these new on-balance sheet assets. In addition, consolidation under FAS 166/167 will result in banking institutions establishing loan loss reserves for assets that return to the balance sheet.

Currently, banking institutions are permitted to include the allowance for loan loss ("ALLL") as part of Tier 2 capital up to an amount equal to 1.25% of risk-weighted assets. For many institutions including Discover, consolidation under FAS 166/167 will result in having ALLL in excess of the 1.25% limit. In this regard, we estimate that consolidation under FAS 166/167 would require Discover to add approximately $1.6 billion to loan loss reserves for the approximately $21 billion in securitized assets that are added to the balance sheet.[1] All of the $1.6 billion would be disallowed under risk-based capital rules as it exceeds the 1.25% cap. This disallowed amount directly diminishes our capital ratios and, thus, our capacity to support additional consumer lending. In this instance, assuming the "well capitalized" minimum for the total risk-based capital ratio of 10%, $1.6 billion in capital would support approximately $16 billion in additional loans.

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[1] As discussed below, the addition to loan loss reserves causes a direct reduction to capital. Estimates are as of August 31, 2009.

The 1.25% cap was developed at a time when banking institutions were not required to hold capital or loan loss reserves against securitized off-balance sheet assets. The cap should be reconsidered with the changes brought by FAS 166/167 since the result is a substantial increase in ALLL with no fundamental change in the underlying risks to the banking institution. In this regard we note the following:

- The impact of disallowing reserves beyond a certain threshold adds to the issue of reserve procyclicality. Not only do lending institutions have to add to reserves during difficult economic times, the existing 1.25% cap forces firms to increase capital levels as well simply to maintain their existing capital ratios since the reserves added above the 1.25% threshold are not counted under risk-based capital rules.

- The 1.25% cap could provide a disincentive for firms to record the appropriate level of reserves. Banking institutions that are at or above the cap would be adversely impacted as reserves are increased. For firms in that position, each incremental dollar of reserves would negatively impact the firm's capital position: as the reserves are recorded, retained earnings (and capital) would be reduced, however, the amount of ALLL that is included in regulatory capital would not change.

- We believe that it is inappropriate to make a determination about a banking institution's capital adequacy without considering the adequacy of reserves as well, particularly given the significant impacts of FAS 166/167. As reserves are the first loss cushion, they are often viewed as a form of capital. Reserve adequacy should be assessed before capital adequacy can be determined. As such, the capital adequacy measures and thresholds should include higher levels, if not all, of the reserves.

For the previous reasons, Discover believes that the 1.25% cap on the inclusion of ALLL in Tier 2 capital should be eliminated or substantially increased.

2. Conforming Capital Rules to U.S. GAAP regarding Treatment of Deferred Tax Assets

Another impact of FAS 166/167 is the creation of deferred tax assets ("DTA") on bank balance sheets which will be disallowable for regulatory capital purposes. As stated above, upon implementation of FAS 166/167, loan loss reserves for the amount of newly consolidated assets will be recorded. The amount added to ALLL net of tax will be recorded against retained earnings resulting in a DTA.[2] Under GAAP, DTAs are permitted to be used against future taxable income during a look forward period of 5 years. In contrast, for regulatory capital calculations, generally DTAs are limited to the lesser of 10% of Tier 1 capital or the amount of the DTA the banking organization is expected to utilize through a two year carryback and a one year look forward period based on a projection of future taxable income.

Discover believes that the regulatory capital treatment of DTAs should be reconsidered by the agencies as the existing limitation will further adversely impact regulatory capital positions of banking institutions. In this regard, Discover believes that the risk-based capital rules should be amended to simply follow U.S. GAAP to avoid having good assets under GAAP disallowed for capital adequacy purposes.

3. Providing a Transition Period for the Regulatory Capital Depletion

The agencies requested comment on whether a phase-in period should be adopted to mitigate the impact of the addition of assets brought onto the balance sheet under FAS 166/167. Discover believes that a phase-in period is necessary and that it should address both the numerator and denominator effects resulting from consolidation under FAS 166/167.

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[2] A DTA is created as a result of a timing difference in the recognition of loan losses for GAAP and tax purposes. For GAAP purposes, losses are accrued when probable and estimable. For tax purposes, losses are generally not recognized until the loans are actually charged-off.

Adoption of a phase-in period would serve to reduce the impact of FAS 166/167 on the U.S. consumers and economy. Without a phase-in period, the likely impact of FAS 166/167 is that banking institutions will seek to raise additional capital, reduce loan balances or both. These actions would have a negative effect on consumers and the economy by increasing the cost and reducing the supply of credit, potentially undermining the broader economic recovery.

In order to mitigate these adverse reactions, Discover believes that the phase-in period should correspond to the average remaining life of the securitization transactions currently outstanding, or for simplicity, a period of three to five years. Discover does not believe that a phase-in period is an appropriate alternative to the permanent changes to the risk-based capital rules related to ALLL and DTAs as discussed above.

Conclusion

Discover appreciates the opportunity to comment on the notice of proposed rulemaking. FAS 166/167 will have a significant impact on banking institutions that use off-balance sheet financing vehicles. It is our hope for the reasons discussed above that the agencies will take actions to mitigate the impact of FAS 166/167 under risk-based capital rules to avoid the impact to consumers and the U.S. economy that would result without action.

Respectfully submitted,

Mark Zaeske
Chief Accounting Officer