THE RISK MANAGEMENT ASSOCIATION
Serving the Financial Services Industry

1801 Market Street • Suite 300 • Philadelphia, PA 19103-1628 • Telephone 215-446-4000 • Fax 215-446-4101 • www.rmahq.org

February 28, 2011

VIA E-MAIL: ***regs.comments@occ.treas.gov***
Office of the Comptroller of the Currency
250 E Street, SW
Mail Stop 2-3
Washington, DC 20219

VIA E-MAIL: ***regs.comments@federalreserve.gov***
Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

VIA E-MAIL: ***comments@fdic.gov***
Mr. Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Advanced Capital Adequacy Framework – Basel II; Establishment of a Risk-Based Capital Floor 75 Federal Register 82317, December 30, 2010; **OCC:** Docket ID: OCC—2010—0009; **FRB:** Docket No. R—1402 and RIN No. 7100—AD62; **FDIC:** RIN 3064—AD58, PIN XXXX-XXXX

Ladies and Gentlemen:

The Risk Management Association Capital Working Group (―CWG") appreciates this opportunity to respond to the Joint Notice of Proposed Rulemaking (―NPR") dated December 30, 2010 dealing with establishment of a risk-based capital floor. The CWG's members consist of senior officers whose responsibility is the measurement and management of risk at some of the largest banking organizations in the U.S. Since the Group's inception in 1999, we have promoted the establishment of appropriately risk-based capital standards.[1]

I. Introduction and Overview

The new NPR has been issued to implement Section 171 of the Dodd-Frank Act. As will be discussed below, we believe that the NPR, as drafted, could have significant

[1] The RMA Capital Working Group members involved in the preparation of this response are listed in an appendix. Individual institutions may be providing their own response to the NPR and/or may hold views that differ from those expressed in this response.

unintended consequences. After an overview analysis, we suggest alternative language that would remove or mitigate these unintended consequences.

Language of Dodd-Frank. The new legislation has two sections that pertain specifically to regulatory capital minimums. Section 171 indicates that the regulators shall establish minimum capital requirements (both for leverage and risk-based standards) for all regulated depository institutions, depository institution holding companies, and non-banking financial companies regulated by the Fed, on a consolidated basis, that "*shall not be less than the generally applicable risk-based capital requirements*" including the generally applicable requirements as they existed at the time of enactment of Dodd-Frank. In our view, the intent of this language is that any "advanced approaches" capital requirements applicable only to large, complex (systemically important) institutions should be no less than the general rules require for all other banks. Further, these general rules should, in the future, be no less stringent than they were at the date of enactment.

Another section of Dodd-Frank – Section 165(a)(1)(A) – requires that

> "…the Board of Governors shall, on its own or pursuant to recommendations by the Council under section 115, establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that …are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks…."

We believe there is a necessary relationship between the two sections– one setting effectively a capital floor for the advanced approaches equal to the capital floor for the general approach, and another saying effectively that the advanced approaches capital standards should be higher than those for the "general" population of banking organizations.

As will be discussed below in detail, the NPR will require advanced approaches institutions in the U.S to use the non-risk-based methods of Basel I to meet the higher minimum capital standards of Basel III. That is, the proposal requires advanced approaches banks to calculate their Tier 1/RWA and Total Capital/RWA two separate ways – one way is via the actual advanced approaches process, the other way is through the general capital treatment for other, "general" banks. The lower of each ratio is then to be used to meet the *capital requirements of the advanced approaches.*

This proposed requirement (that the advanced banking company use Basel I methods to meet the capital ratio requirements of the advanced approaches) would, in our view, be considered to meet the language of section 171 *only if the agencies were to make the general approach minimum capital ratio requirements identical to those of the Basel III approach.* But section 165(a)(1)(A) clearly requires, on a consolidated company basis, that the capital ratio minimum requirements for the advanced companies be *higher* than for the general approach.

Thus, in our view, the language of the NPR does not meet the requirement of section 171 of Dodd-Frank, which says that the advanced bank should demonstrate that it can meet two different sets of capital standards:

a) The advanced bank should calculate its capital requirements as if it were still under the general capital standards, to see if it meets the minimum capital requirements <u>under the general capital standards</u>. Section 171's specific reference to Prompt Corrective Action rules indicates the desire to relate the calculation of capital ratios, using the general <u>methodology</u>, to the capital ratio <u>minimums</u> of the general approaches. Additionally, 171's specific requirement -- that the general approach's methodology in the future should be no less stringent than the methodology as of the date of enactment -- further indicates that federal legislators were thinking in terms of the advanced bank's need to continually use general approach methodology to meet evolving general approach capital ratio standards.

b) The advanced bank should also calculate its capital requirements under the advanced approaches (i.e., under Basel III as it is evolving), to see if it meets the minimum capital requirements under the advanced approaches.

The genesis of the NPR can be found in the language in the 2007 advanced approaches regulation which establishes a set of phased-in floors for the Basel II approach. Under this phase-in, after the bank completes its parallel-reporting period, its Basel II capital ratios cannot rise unfettered due to it having low risk assets. Rather, the Basel II bank must use Basel I methods to compute RWA, then compute constrained capital ratios in which the Basel II RWA must be no lower than 95% of the Basel I methodology for computing RWA in the 1st year after the parallel run; no lower than 90% of the Basel I method for computing RWA in the 2nd year; and no lower than 85% of the Basel I method for computing RWA in the 3rd year.[2]

Agency personnel, in helping to draft Dodd-Frank, probably were seeking a *permanent* 100% floor consisting of the Basel I methodology, rather than the 3-year phase-in. But the NPR does not establish a floor equal to 100% of what Basel I requires -- it changes the thrust of the 2007 regulation completely. Note that the 2007 regulation specifically says that the bounded floor (to the RWA calculation), during the transition period, must be used for PCA purposes to determine into which capital adequacy class the bank falls. This, in fact, is what section 171 refers to and what would be meant by a 100% floor – the bank should calculate the capital ratio two different ways and then use the lower for purposes of the PCA standards (and other rules in which capital ratios are used).[3] This is not equivalent to using the lower of the two ratios to meet the Basel II capital ratio standards and their about-to-be-dramatically-raised Basel III counterparts.

---

[2] See pp. 69301-69302, Federal Register, vol. 72, number 235, December 7, 2007, especially Table A and the language following the table regarding what is to be done with the constricted calculation of the capital/RWA ratios.
[3] See *ibid*, second full paragraph on p. 69302.

Effects of the Proposal. As indicated above, the new proposal calls for the use of the general capital methodology to meet the advanced approaches minimum ratio requirements. We believe this language should be evaluated in the context of the very dramatic changes that are now being made to both the Basel II/III rules and to the generally applicable rules.

Specifically, when Basel III is fully phased in, it will have dramatically higher minimum capital ratio requirements than the 4% Tier 1/RWA minimum and the 8% Total Capital/RWA minimum now called for in the advanced approach.[4] Additionally, Basel III trading account capital requirements will be dramatically higher than those now embedded in Basel II (and the U.S. version of Basel II known as the advanced approaches). Finally, and most importantly, the U.S. agencies are now in the process of including the new BIII trading account/market risk rules, subject to some exceptions, not only for advanced institutions but also for non-advanced (general) banks.[5]

When all of these proposals are fully embedded in the U.S. rules, it is clear that the capital requirements for advanced banks under Basel III will be dramatically higher than under the current advanced approaches (Basel II as never practiced in the U.S.). Additionally, however, so long as the *general rules* include the new dramatically higher trading account/market risk requirements (even though few non-advanced banks have significant trading activities), the Basel III methodology will generate somewhat *higher* capital ratios than if the advanced bank were using the (newly changed) Basel I rules in the U.S.

This is because, as shown in various Quantitative Impact Surveys, Basel II/III treatment of capital for the banking book uses a risk-based process that encourages advanced banks to hold safer assets in the banking book. That is, Basel III attaches lower risk-weights to low-risk assets than does Basel I; and Basel III attaches higher risk-weights to high-risk assets than does Basel I. Advanced banks current banking book portfolios contain higher dollar percentages of low-risk assets than high-risk assets. Therefore, banking book RWA calculations result in lower RWA for the banking book under BIII than under Basel I. But new trading account methodologies under BIII result not only in higher RWA for the trading account than under Basel II but also a higher combination of trading account + banking book RWA under Basel III than under Basel I as it now stands.

The net effect of the NPR proposal would therefore be to require U.S. advanced banks or BHCs to a) hold significantly higher capital for identically the same portfolio as foreign advanced institutions, and b) negate one of the intended effects of Basel II/III to move banks toward even safer banking book positions.

---

[4] With the capital conservation buffer (but without the countercyclical capital buffer), the fully phased in Tier 1/RWA ratio minimum will be 8.5% instead of 4% and the Total Capital/RWA minimum will be 10.5% instead of 8%.

[5] See Risk-Based Capital Guidelines: Market Risk, Federal Register, January 11, 2011, pp.1890 to 1921.

We provide specific language changes to the proposal that would eliminate these potentially deleterious effects and also meet the letter of Sections 171 and 165 of Dodd-Frank.

I. Analysis of the proposal regarding minimum capital requirements.

As the basis for our concern, note that Dodd-Frank Section 171 specifically defines "generally applicable leverage capital requirements" and "generally applicable risk-based capital requirements" to mean requirements as established by the agencies to apply under Section 38 (Prompt Corrective Action or PCA) of the FDI Act. The PCA requirements, in turn, list 5 categories of capital adequacy with respect to the 3 capital ratios specified in Section 38. These capital categories are "well-capitalized", "adequately capitalized", "undercapitalized" "significantly undercapitalized", and "critically undercapitalized." [6] Banking organizations are to be placed within one of these 5 categories depending on the levels of 3 capital ratios – a) the Tier 1 to Total Assets leverage ratio; b) the Tier 1/RWA (Risk-Weighted-Assets) ratio; and c) the Total Capital/RWA ratio. From the point of view of "minimum" capital requirements, most banks believe that they need to be characterized as "well capitalized" in order to compete for funds and to keep their credit customers. Thus, most banks view their minimum capital requirements for purposes of PCA as a) a 5% leverage ratio; b) a 6% Tier 1/RWA ratio; and c) a 10% Total Capital/RWA ratio – as specified within Section 38 legislation.

Since Dodd-Frank Section 171 defines "generally applicable" *in relation to PCA*, we believe that the legislation requires calculation of the ratios under the advanced approaches and the generally applicable approaches, then requires banks to use the lower of each ratio to see what category the banking organization falls into with respect to PCA and whatever other minimum ratio requirements are required within the generalized approach.[7]

Under this view:

1) The language does not satisfy the language of Section 171 of Dodd-Frank, because it refers to using the lower of the two ratios for purposes of meeting the advanced approaches language (section 3 of the advanced approaches rules). This section of the advanced approaches refers only to two ratios – 4% for Tier 1/RWA and 8% for Total Capital/RWA -- leaving open the question of how banking organizations make capital calculations to meet the "well-capitalized", "undercapitalized", "significantly undercapitalized" and "critically undercapitalized" portions of the statutory language in Section 38 (PCA). The language of the NPR is also silent on the issue of using the Basel I versus Basel III calculations for purposes of meeting the leverage ratio standard in PCA.

---

[6] Of the 5 categories of capital adequacy, only the "critically undercapitalized" category is defined solely by the level of the leverage ratio (i.e., a leverage ratio equal to or less than 2.0%).

[7] Since the leverage ratio is not risk-based, presumably this ratio would be no different for an advanced bank as for a general bank.

2) The language of the NPR also raises the question of what happens when the U.S. agencies rewrite the advanced approaches rules to meet the new Basel III requirements. These new requirements include many changes to the way in which RWAs are calculated and, as well, include new minimum ratio requirements for variously defined capital ratios, including Tier 1 and Total capital risk-based requirements. These new requirements also include a capital conservation buffer and, potentially, a countercyclical capital buffer. When the U.S. agencies' advanced approaches regulation is altered and fully phased in to reflect the new Basel III minimum ratios, the new advanced approaches minimum ratios will more than double for Tier 1/RWA and go up by more than 30% for Total Capital/RWA minimum ratios. Additionally, the types of capital that can be used to meet either the Tier 1 standard or the Total capital standard are greatly diminished.

Thus, we believe that the NPR's method of interpreting the Act would have two potentially unintended consequences. First, it would result in U.S. advanced banking institutions having to hold significantly higher capital than foreign advanced institutions. Second, it would effectively negate much of the progress that has been made in calculating risk-based capital ratios meant to provide proper incentive for advanced banks to hold safer assets and rid themselves of riskier positions.

Let's begin with this issue of competitive equity regarding U.S. large, complex financial institutions. Why might the use of Basel I methodology to meet Basel III minimum capital ratios entail higher effective capital charges for U.S. advanced banks than for non-U.S. banks? Note that BIII entails very significant increases in the risk-weights accorded to positions in the trading account than under Basel II. Significantly, no longer will simple Value-at-Risk calculations be used but rather stressed VaR calculations (that serve as additions to the unstressed VaR charges). Other major increases in effective RWA calculations were incorporated in Basel regulations in 2009 and 2010.[8] Finally, the U.S. is proposing to incorporate these Basel increases in RWA for trading account positions within their own general market risk rules, with the exception of specific risk charges based on external ratings.[9] Thus, the new U.S. market risk/trading account rules, when fully completed to substitute other methods for external-ratings-based methods, will involve RWA calculations for advanced banks for trading account positions under new general Basel I rules and under new BIII rules that are at least as high as for the rest of the Basel countries.

---

[8] See Basel publications in July 2009: Revisions to the Basel II Market Risk Framework; Guidelines for Computing Capital for Incremental Risk in the Trading Book; and Enhancements to the Basel II Framework. In June 2010, see Changes to the Revisions to the market risk framework.

[9] See Risk-Based Capital Guidelines: Market Risk, Federal Register, January 11, 2011, pp.1890 to 1921. With regard to external-ratings-based capital charges, these are prohibited under Dodd-Frank. Also, analysis suggests that non-ratings-based methods for assigning capital to securitization positions are more economically sound and often result in higher RWA attributions; see RMA CWG Response to the ANPR Regarding Alternatives to the Use of Credit Ratings in the Risk-Based Capital Guidelines of the Federal Banking Agencies, October 25, 2010.

Meanwhile, the old Basel I, as practiced only in the U.S. among the Basel countries, is not very risk-sensitive with regard to banking book positions such as the loan portfolio. A highly-rated (via internal rating OR external rating) corporate bond or loan receives the same 100% risk-weight as a junk-rated loan. Thus, the various Quantitative Impact Surveys (QIS) show that absolute RWAs computed on positions in the banking book are likely to *fall* as the result of moving from Basel I to Basel III. So, if trading account effective RWA calculations are likely to be nearly the same in the U.S. and the rest of Basel for the "generally applicable" capital rules, but banking book RWA will likely fall under BIII relative to BI, the effect of this NPR (to use a non-risk-based capital calculation for advanced organizations to meet Basel III ratio minimums) will result in *lower reported capital ratios* than the BIII ratios reported by other global institutions.

While we are concerned about the issue of competitive equity, we remain proponents of best-practice risk measurements and their use in the setting of formal risk-based capital requirements. Therefore, we continue to support the U.S. agencies in dealing with parts of the Basel III package that could be improved, even if such best-practice approaches result in higher capital requirements for certain activities. For example, we have already expressed our support for continued U.S. work on improving the treatment of capital for securitization positions.

Also, the U.S. is one of only a very few Basel countries that have Pillar 2 capital requirements that are a) institution specific; b) by definition are higher than the Basel stated capital minimums; and c) are very real and binding. Via the bank-by-bank supervisory process the U.S. agencies are now requiring, and will continue to require in the future, significantly higher risk-based capital ratios than the minimums specified either within Section 38 of the FDI Act or within the advanced approaches rules.[10] If U.S. regulators thought it was important for U.S. advanced banks to be subject to more stringent capital standards than the other Basel-nations' banks our regulators could use the Pillar 2 process to achieve this objective.

A second effect of the NPR would be to provide disincentives for U.S. advanced organizations to continue to hold low-risk assets in the banking book. This is because global market standards, not U.S. regulations, will determine the spreads on credit instruments of a given level of risk. If, for a given instrument, the effective U.S. bank Basel III capital requirement is significantly higher than for the rest of the world's banks, the U.S. bank cannot afford to invest in the long run in such an instrument.

We also ask the regulators to, in connection with the finalization of the current NPR, provide new regulatory language for implementing section 165(a)(1)(A) of the new Act, requiring the Fed to establish prudential requirements for covered nonbank companies and for BHCs with assets of $50 billion or more, on a consolidated basis, that are more stringent than for the general population of banking companies. To achieve this legislative directive, the Federal Reserve needs only to set the minimum capital ratio

[10] Note also that Dodd-Frank, for the first time, specifically applies the leverage ratio requirement under Section 38 to bank holding companies supervised by the Federal Reserve.

requirements for general BHCs in the U.S. at levels that are a) at least as high as required in Section 38 (PCA) and b) not as high as required for advanced approaches institutions.

In summary, we respectfully ask the U.S. agencies to provide clarification of their objectives with regard to capital ratio minimums. If the agencies intend to use Basel I methods to meet the higher Basel III capital ratio standards, we urge the agencies to clarify this intent and it's supporting rationale. We do not view this as a requirement flowing from the new Dodd-Frank legislation. Alternative approaches, which meet both the letter and intent of the law, are discussed below.

The rest of our response deals with each of the questions asked of the respondents to the NPR. In our discussion under Question 5 below, we offer specific language that would alleviate our major concerns with the NPR.

II. <u>Answers to questions in the NPR</u>.

<u>Question 1</u>:

"How should the new proposed rule be applied to foreign banks in evaluating capital equivalency in the context of applications to establish branches or make bank or nonbank acquisitions in the U.S., and in evaluating capital comparability in the context of foreign bank FHC declarations?"

U.S. banks naturally call for competitive equity on this subject by requiring all U.S. subsidiaries of foreign parents to hold capital in the subsidiary equivalent to the capital required under U.S. law. That is, the U.S. sub of the foreign parent would also be subject to the permanent minimum(s) of Section 171 of Dodd-Frank (i.e., Basel I as of 2010 or as amended in the future). Such banks, if owned by a foreign entity that meets our own definition of "advanced" or "systemically important," would have to calculate both the Basel I and the Basel III capital requirements for purposes of PCA and for purposes of meeting, alternatively, the general capital requirements in the U.S. and the advanced approaches requirements in the U.S.

However, such a requirement for foreign owners would be largely a matter of record-keeping, not real and binding capital requirements. That is, if the Basel I capital requirement for the U.S. subsidiary were indeed higher than the Basel III requirement, the foreign parent could borrow funds to purchase additional equity in the U.S. sub. Thus, such a rule would not affect the consolidated global capital requirements of the foreign-based company. The record-keeping burden, in turn, would be similar to that of any large U.S. banking company that was subject both to Basel III and to Basel I under Section 171 of Dodd-Frank.

<u>Question 2</u>:

"The agencies seek comment generally on the impact of a permanent floor on the minimum risk-based capital requirements for banking institutions subject to the advanced

approaches rules, and on the manner in which the agencies are proposing to implement the provisions of section 171(b) of the Act."

Our response to the manner in which the agencies are proposing to implement Dodd-Frank is provided in Section II of this response, above. Additionally, we would like to reiterate what we have said over the last decade or so – that truly risk-based capital minimums are always preferable to arbitrary minimums, from the point of view of making banks more sound. Thus, any attempt by a bank to invest in safer instruments which would attract lower capital requirements under Basel III will be frustrated by having to keep effective capital equal to the Basel I minimums for a low-risk asset. Similarly, the leverage ratio requirement in the U.S., should it turn out to be higher than the effective leverage ratio minimum set within the new Basel III, will also preclude U.S. banks from making less-risky investments.

To see a specific example of the U.S. versus non-U.S. effect of the NPR, assume that U.S. Bank A and a non-U.S. Basel Bank B have the same asset size and identical trading account positions, and both are advanced banks. Both banks have $75 in Tier 1 capital. But, Bank A – the U.S. advanced bank -- holds assets in the banking book that are safer than those in the foreign bank. The example is intended to show only the effect of imposing on the U.S. bank a Basel I-based floor to capital requirements for BIII purposes (the leverage ratio is not considered).

Example of Capital Floor under the NPR's interpretation of Section 171 of Dodd-Frank: Taking "the lower of" for Basel III compliance for the U.S. advanced bank *

	Bank A Basel I	Bank A Basel III	NPR for Bank A	Foreign Bank B
Tier 1 Capital	**75**	**75**		**75**
RWA	**925**	**850**		**875**
Computed Ratios				
Tier 1 Capital/RWA	8.11%	8.82%	**8.11%**	8.57%
STANDARDS				
Well-capitalized Tier 1 (PCA) required	6.00%			
Basel III minimum Tier 1 Capital/RWA		8.50%	**8.50%**	**8.50%**
Meet Capital Requirements?				
Tier 1 Capital/RWA	**Yes**	**Yes**	**No**	**Yes**

In the example, the U.S. bank fails one of its Basel III capital ratio requirements, even though it is demonstrably safer than the foreign bank. A similar example can be constructed entailing two U.S. advanced banks, one with a safer portfolio than the other.

We understand that Section 171 of Dodd-Frank enjoys significant political backing, and we can't disagree with the intent to make U.S. banks more sound, even though it moves banking regulation away from a truly risk-based set of methodologies. The important point, however, is that there are alternative interpretations of Section 171 that would meet the letter of the new law and its intent, in our view, while still allowing the U.S. to fully honor its commitment to Basel II and its largely risk-based methodology. We also support the U.S. agencies in making sure that any U.S. version of Basel III is structured in such a way as to remove or replace specific portions of Basel III that do not represent best regulatory practice.

Question 3:

The NPR next deals with the subject of low-risk assets of non-depository institutions that may become subject to this Section of Dodd-Frank (such as insurance companies that become covered institutions under the new law) for which there are no explicit capital risk-weights under Basel I. For such assets, Basel I in the U.S. sets the risk-based asset weight at 100% (Total Capital charge of 8%).

For such assets, the proposal is that the exposures receive the capital treatment for BHCs "under limited circumstances." These limited circumstances apply to assets not authorized to be held by depository institutions except via "debt previously contracted or similar authority" (i.e., when the bank owns collateral of a defaulted loan which such collateral is otherwise impermissible) and the otherwise impermissible asset entails risks "similar to the risks of assets that receive a lower risk weight."

The question in the NPR asks:

"For what specific types of exposures do commenters believe this treatment is appropriate? Does the proposal provide sufficient flexibility to address the exposures of depository institution holding companies and nonbank financial companies supervised by the Federal Reserve? If not, how should the proposal be changed to recognize the considerations outlined in this section?"

It is not clear that this proposal is initiated by specific language in Dodd-Frank. Frankly, whether legislated or not, this proposal sounds as if it is the direct result of lobbying by the insurance industry. Examples of such assets might include policy loans, which can be effectively fully collateralized. Since banks don't issue insurance policies, they have no such loans (which can be an important percentage of assets at a major insurance company).

Our concern with the proposal is that it is not symmetrical, either with respect to the treatment of low-risk loans at banks versus insurance companies, or with respect to the treatment of low-risk versus high-risk assets at either insurance companies or banks. First, if a particular insurance company asset should properly receive a capital risk-weight less than 100%, shouldn't a similar low-risk asset at banks also receive a low risk-weight? For example, a fully collateralized or over-collateralized consumer loan that is not a mortgage at banks still receives a 100% risk-weight under Basel I; the same treatment is applied to a fully collateralized commercial loan. Why should a collateralized loan from an insurance company be afforded more liberal (and more appropriate) treatment for the insurance company but not for banks?

Similarly, why should the proposal be only in one direction? That is, under the proposal, an exception would be made to the 100% risk-weight for non-specified assets only for low-risk assets. What about insurance company assets that might be generally impermissible for banks and truly should involve higher capital risk-weights than 100%? For example, a significant asset at major insurance companies is an intangible asset known as Value of Business Acquired ("VOBA"). This asset can be subject to fairly significant changes in carrying value as market conditions change with respect to the likely payout on certain variable annuities versus the returns to certain assets. It could be argued that such intangible assets should receive risk-weights in excess of 100% (Total Capital charge in excess of 8%) or even that the assets should be deducted from capital for regulatory capital purposes (as are certain intangible assets of banks).

Therefore, we believe that including entities such as insurance companies under the auspices of the minimum capital requirements brings to the fore the issue of making future capital requirements for large institutions as fully reflective of best-practice risk measurement as possible. Presumably, non-banking companies that come to fall under purview of the banking agencies will be sufficiently large that they can shoulder the extra costs of having proper risk-based internal capital adequacy systems. However, significant work, accompanied by significant public comment, is needed regarding how the Fed will actually implement capital charges for non-banking covered institutions.

<u>Question 4</u>:

Next, the NPR deals with the likelihood that the generally applicable capital rules (Basel I in the U.S.) will undergo changes from time to time. As required by Dodd-Frank, these new versions of Basel I would become the de facto minimums – because Dodd-Frank further requires that any new Basel I standards must not be "quantitatively lower" than Basel I as of the date of enactment.

The agencies propose in this NPR that advanced banks won't have to calculate two sets of alternative minimums – the current Basel I as it evolves, plus the Basel I as of July, 2010 – in addition to calculating the Basel III minimum. That is, the agencies intend to make a calculation each time they change Basel I that the new version of Basel I is not "quantitatively lower" than the old version. The agencies then ask for help in how to make this calculation.

The question reads as follows:

"The agencies request comment on the most appropriate method of conducting the aforementioned analysis, including potential quantitative methods for comparing future capital requirements to ensure that any new capital framework is not quantitatively lower than the requirements in effect as of the date of the enactment of the Act."

In our view, this calculation should be aimed at making Basel I more risk-sensitive (like Basel III). That is, when making changes to Basel I for the general bank population, the regulator should hope to include changes that lower the risk-weights for truly less risky positions, and raise the risk-weights for truly greater-risk positions.

In order to make changes to Basel I that satisfy the letter of the Dodd-Frank language, regulators might include enough increases in the weights for high-risk assets to offset decreases in the weights for lower-risk assets. To achieve the letter of the law, regulators might look at the consolidated industry balance sheet at the time of the proposed changes and calculate how the set of newly proposed changes to Basel I would affect the level of the consolidated industry Tier 1/RWA ratio. If there were no change in this ratio, or a decrease in the ratio, this could constitute evidence that the proposed changes make the new standards "not quantitatively lower" than the old standard. That is, the agencies would be making RWA-reducing changes for low-risk positions in amounts approximately equal to RWA-increasing changes for high-risk positions.

As non-advanced banks in the U.S. responded to these changes by altering portfolio composition toward lower-risk assets, the actual industry consolidated Tier 1/RWA might rise (as the denominator falls). This would make sense from the perspective of the capital ratio actually reflecting bank soundness. But the ability of banks to use such an improvement in the Tier1/RWA ratio to increase leverage, by expanding lending to the lower-risk segments of the credit market, would ultimately be stymied by the existence of the legislated PCA minimum leverage ratio requirement (which is now, under Dodd-Frank, unavoidable at the consolidated level for large BHCs).

Again, we understand the political necessity of continuing with a leverage ratio requirement, even though we disagree with the effect of such a minimum ratio – it does NOT make banking organizations more sound.

<u>Questions 5</u>:

Finally, the NPR asks the following –

"The agencies seek comment on all other aspects of this proposed rule, including costs and benefits. What, if any, changes should the agencies make to the proposed rule or the risk-based capital framework to better balance costs and benefits?"

We have answered this question substantively in Section II of this response. More specifically, we offer the following suggestion for drafting the key paragraph in the NPR:

"Each quarter, each banking organization subject to the advanced approaches rules must calculate its tier 1 and total risk-based capital ratios as calculated under <u>both</u> the general risk-based capital rules and the advanced approaches risk-based capital rules. The banking organization would then use the tier 1 ratio and total risk-based capital ratios calculated under the general approach to compare against the minimum capital ratio requirements for the general approach, including the requirements of Prompt Corrective Action found in Section 38 of the FDI Act. Separately, the banking organization would use the tier 1 and total risk-based capital ratios calculated under the

advanced approaches to compare against the minimum capital ratio requirements for the advanced approaches, including the requirements of Prompt Corrective Action found in Section 38 of the FDI Act."

We can think of no other substantive way of satisfying the Dodd-Frank language while not creating potentially significant capital-requirement differences between U.S. advanced organizations and the rest of the world's large banking organizations. The final rule preamble might also remind the reader that the U.S. agencies intend to continue to assess Pillar 2 capital requirements that are significantly higher than either the Basel I or the Basel III minimums, or the Prompt Corrective Action rules, on a confidential, institution-by-institution basis. Also, the final rule preamble might indicate that, in order to meet the requirement of section 165(a)(1)(A), the Federal Reserve intends to amend its general approach rules for holding companies to set higher consolidated capital minimum ratios than at present, but these ratios will be somewhat below those of the advanced approaches, as required by Dodd-Frank.

Please feel free to contact Edward J. DeMarco, Jr. at (215) 446-4052 or via email at edemarco@rmahq.org or Mark Zmiewski at (215) 446-4085 or via email at mzmiewski@rmahq.org.

Sincerely,

Edward J. DeMarco, Jr.,
General Counsel

Mark A. Zmiewski,
Director

RMA Capital Working Group institutions participating in the preparation and/or review of this response:

Capital One
JPMorganChase
M&T Bank
State Street Corporation
Union Bank of California
US Bancorp

RMA would like to thank the following individuals who participated in the preparation and review of this response: Michel Araten, Managing Director, JPMorgan Chase & Co.; Joseph Lyons, Vice President Regulatory Policy / Risk Management, JPMorgan Chase & Co.; Jacob Seljan, Senior Vice President, Credit Risk Analytics, U.S. Bancorp; Lyubov Zech, Vice President, Credit Risk Analytics, U.S. Bancorp.; William H Schomburg, III, Senior Vice President, Director of Economic Capital, State Street Corporation; Hans Helbekkmo, Senior Vice President Portfolio Risk Management, Union Bank of California; Desta Gebre-Medhin-Huff, Vice President, Basel II Commercial Credit, Union Bank of California.

.