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PNC

October 22, 2012

Ms. Jennifer J. Johnson
Secretary (Docket No. R-1442; RIN 7100-AD87)
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue
Washington, D.C. 20551

Office of the Comptroller of the Currency
Mail Stop 2-3 (Docket Ids CC—2012-0008, OCC-2012-0009, OCC-2012-0010
RIN 1557-AD46)
250 E Street, SW
Washington, D.C. 20219

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS (RIN 3064-AD95, 3064-AD-96, 3064-AD-97)
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Regulatory Capital Rules:
Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; Proposed Rule ("Basel III NPR")[1]
Advanced Approaches Risk-Based Capital Rule, Market Risk Capital Rule; Proposed Rule ("Advanced Approaches NPR")[2]
Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; Proposed Rule ("Standardized Approach NPR")[3]

Ladies and Gentlemen:

The PNC Financial Services Group, Inc. ("PNC") appreciates the opportunity to provide comments on the Basel III NPR, the Advanced Approaches NPR, and the Standardized Approach NPR issued by the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Office of the Comptroller of the Currency ("OCC"), and the Federal Deposit

[1] 77 Fed. Reg. 52792 (Aug. 30, 2012).

[2] 77 Fed. Reg. 52978 (Aug. 30, 2012).

[3] 77 Fed. Reg. 52888 (Aug. 30, 2012).

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Insurance Corporation ("FDIC") (collectively, the "Agencies"). PNC is a diversified financial services company with approximately $301 billion in assets, as of September 30, 2012. PNC's sole bank subsidiary, PNC Bank, National Association ("PNC Bank"), had approximately $293 billion in assets as of the same date. Our principal lines of business are retail banking, corporate and institutional banking, asset management, and residential mortgage lending.

The proposed rules included within these notices (the "Proposed Rules") represent the most significant and comprehensive changes to the capital framework for banks and bank holding companies (collectively, "banks") since the Agencies' implementation of the initial Basel Accord in 1989. In this regard, the Proposed Rules would not only implement the Basel III framework adopted by the Basel Committee on Banking Supervision ("Basel Committee"),[4] but also would fundamentally revise the risk-weighting framework for assets adopted under the original Basel Accord ("Basel I").

PNC has long supported the fundamental objectives of Basel III, which are to strengthen the overall resiliency of the banking industry and the financial system by strengthening the quality, quantity and transparency of regulatory capital and enhancing the risk coverage of the capital framework. In addition, we support the Agencies' efforts to improve the risk-sensitivity of the regulatory capital rules. We believe that the proper calibration of regulatory capital rules to the relative risk of assets and activities is critical to ensuring that capital requirements (i) promote the safety and soundness of banks and the stability of the financial system; (ii) facilitate the availability of credit on prudent, risk-adjusted terms to support long-term, sustained economic growth, and (iii) minimize the potential for capital arbitrage.

PNC believes, however, that a number of changes to the Proposed Rules are necessary to properly align the Proposed Rules with the risk of exposures, reflect the actual loss-absorption capacity of capital instruments, avoid unintended and adverse consequences, and improve the transparency and administration of the Proposed Rules. Part I of this letter addresses several important concerns with the Basel III NPR; Part II addresses several important concerns that cut-across the three different NPRs; and Part III addresses our concerns with the provisions of the Standardized Approach NPR governing residential mortgages. As discussed in detail below, our most important recommendations are that the Agencies—

- Clarify, consistent with Agency precedent, that firms predominately or significantly engaged in providing discretionary or non-discretionary investment or financial advisory services are not a "financial institution" for purposes of the required deductions from capital for unconsolidated investments in the capital stock of a financial institution;

[4] Basel Committee, *Basel III: A global regulatory framework for more resilient banks and banking systems* (revised June 2011) ("Basel III Framework").

- Retain the "AOCI filter" for available-for-sale debt securities for which fair value changes are predominately attributable to changes in benchmark interest rates, including obligations of the Treasury, a U.S. agency and U.S. government sponsored enterprises ("GSEs"), as well as obligations fully guaranteed as to the payment of principal and interest by a U.S. agency or GSE; and

- Modify the minority interest rules so that they do not apply to (i) eligible REIT preferred securities in light of the demonstrated loss-absorption capacity of such securities, and (ii) bank-issued Additional Tier 1 and Tier 2 capital instruments in light of the strong protection such capital provides to depositors, insured banks and the Deposit Insurance Fund and the disparate and adverse impact such rules would have on U.S. banks as a result of the unique organizational structure of U.S. banking organizations.

Where our comments respond to a specific question posed by the Agencies, we have indicated this parenthetically in the section headings below.

PNC also has participated in the development of the joint comment letters submitted by The Clearing House Association and the American Securitization Forum (the "TCH/ASF Comment Letter") and the American Bankers Association, the Securities Industry and Financial Markets Association, and the Financial Services Roundtable (the "ABA/SIFMA/FSR Comment Letter"). The recommendations contained in this letter are intended to supplement the comments contained in those comment letters.

I. <u>BASEL III NPR</u>

A. <u>Capital Deduction for Investments in Unconsolidated Banking, Financial and Insurance Entities</u> (Basel III NPR, Q. 32)

The Basel III Framework provides for a banks to deduct from its regulatory capital significant and non-significant investments in the capital of unconsolidated "banking, financial and insurance entities" that exceed certain thresholds (the "Financial Entity Deductions").[5] When the Basel Committee originally proposed these deductions for unconsolidated investments in banking, financial and insurance entities, the Committee indicated that they were intended to "remove the double counting of capital in the banking sector and limit the degree of double counting in the wider financial system" by reducing the "potential for capital losses at one financial institution from immediately resulting in the loss of capital at a bank that holds an

[5] <u>See</u> Basel III Framework at ¶ 80-84 and ¶ 87-88.

investment in such a financial institution."[6] In this way, the deductions were intended to help reduce systemic risk and procyclicality.[7]

Section 22 of the Proposed Rules would implement the deductions for unconsolidated investments in "banking, financial and insurance entities" required by Basel III.[8] However, the Proposed Rules would apply these deductions to any "financial institution" and broadly define this term to include not only banks, insurance companies and other financial institutions that—like banks and insurance companies—are engaged in core financial intermediation activities as principal and subject to consolidated prudential capital requirements, but also a range of other entities. For example, under the Proposed Rules, a "financial institution" would include any commodity pool and any entity that would be a "covered fund" for purposes of the so-called Volcker Rule (12 U.S.C. § 1851) (other than certain public welfare funds and small business investment companies). Importantly, though, the Proposed Rules would exclude from the definition of a "financial institution" a company that is predominately or significantly engaged in "investment or financial advisory activities."

PNC has a significant interest in the manner in which the Basel III deductions for investments in banking, financial and insurance entities are implemented in the United States in light of PNC's investment in BlackRock, Inc. ("BlackRock"). As of June 30, 2012, PNC had a 22 percent economic interest in BlackRock. PNC accounts for its investment in BlackRock under the equity method of accounting, and BlackRock's financial statements are not consolidated with those of PNC for financial or regulatory reporting purposes.

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6 See Basel Committee, *Consultative Document, Strengthening the resilience of the banking sector*, ¶ 101 (Dec. 2009) ("Basel III Consultative Document").

7 Id.

8 See Proposed Rules at § 22(d), (c)(4) and (c)(5). In general, the Proposed Rules would require that a bank deduct from its common equity tier 1 capital ("CET1") the amount of its significant investments in a banking, financial or insurance entity in the form of common stock to the extent the amount of such investments, net of associated deferred tax liabilities ("DTLs"), exceed (i) 10 percent of the organization's CET1, or (ii) 15% of the organization's CET1 when aggregated with the organization's mortgage servicing assets ("MSAs") and deferred tax assets arising from temporary differences that the organization could not realize through net operating loss carrybacks (in each case, net of associated DTLs). See Proposed Rules at § 22(d). In addition, the Proposed Rules would require that a bank apply the corresponding deduction approach to its non-significant investments in the capital stock of an unconsolidated banking, financial or insurance entity to the extent such investments (net of associated DTLs) exceed 10 percent of the organization's CET1, as well as its significant investments in the capital stock of such entities that are not in the form of common stock. See Proposed Rules at § 22(c)(2), (4) and (5).

As discussed further below, PNC believes that the proposed definition of a "financial institution" goes beyond the scope contemplated by the Basel Committee when it adopted the deductions for unconsolidated investments in "banking, financial and insurance entities" and is not necessary to achieve the goals of the Basel Committee or protect U.S. banks and the financial system. In this Part I.A, we—

- Set forth our concerns with the proposed definition of a "financial institution" and propose an alternative framework for defining a "financial institution" for purposes of the Financial Entity Deductions that we believe is more consistent with the objectives of the Basel III Framework and the varying degree of risks—both to an investing bank and the financial system—of unconsolidated investments in different types of entities;

- Specifically address the proper application of the Financial Entity Deductions to entities that are predominately engaged in investment or financial advisory activities. As discussed further below, we support the Agencies' determination that investments in entities significantly or predominately engaged in investment or financial advisory activities should not be subject to the Financial Entity Deductions and believe that, consistent with Agency precedent, "investment or financial advisory activities" should include both discretionary and non-discretionary advisory services provided as agent to clients, including investment companies registered with the Securities and Exchange Commission ("SEC");

- Explain why non-guaranteed separate account assets, as well as collateral held under securities lending arrangements entered into on behalf of such accounts, should be excluded from a company's assets for purposes of determining whether the company is "predominately engaged" in insurance or other financial activities; and

- Suggest modifications to the "look-through" required for indirect unconsolidated investments in financial institutions to avoid the double-counting of investments and reduce the practical difficulties associated with this requirement.

Importantly, the Basel Committee expressly left the definition of a "financial" entity to the discretion of national governments as they implement Basel III.[9] Thus, the Agencies have both the flexibility and the discretion under the Basel III Framework to implement the recommendations outlined below.

[9] See Basel Committee, *Basel III definition of capital - Frequently asked questions*, p. 10 (Dec. 2011).

1. Financial Entity Deductions Should Apply Only to Unconsolidated Investments in Entities Subject to Consolidated Regulatory Capital Requirements and Other Entities Engaged in Core Financial Intermediation Activities as Principal (Basel III NPR, Q. 32)

As indicated above, the Financial Entity Deductions were adopted by the Basel Committee in order to limit the "double counting" of regulatory capital within the banking and financial system and to reduce the potential for losses at one financial institution to immediately result in the loss of capital at a bank that holds an investment in such financial institution.[10] As the Agencies have implicitly recognized in the Proposed Rules, it is not appropriate or necessary to apply the Financial Entity Deductions to every investment in an unconsolidated entity that engages, either predominately or otherwise, in any type of "financial" activity.[11] In other words, the Financial Entity Deductions are appropriate for certain types of unconsolidated investments in entities engaged in financial activities, while the risk of other types of unconsolidated investments in entities engaged in financial activities is more appropriately addressed under the general risk-weighting framework for equity investments (including the heightened risk-weightings that would apply to equity investments under the Standardized Approach).

In determining where to draw this line, we believe the Agencies should be guided by both the text and purposes of the Financial Entity Deductions in the Basel III Framework. In this regard, the only two types of entities that the Basel III Framework specifically indicates should be subject to the Financial Entity Deductions are banks and insurance companies. Banks and insurance companies engage as principal in core financial intermediation activities (deposit-taking and lending, and underwriting insurance and/or issuing annuities) and are subject to consolidated prudential capital requirements. We believe these same considerations should govern the determination of what entities should be considered a "financial" entity for purposes of the Financial Entity Deductions. Indeed, it would be anomalous to define a "financial" entity to include a wide range of entities that, unlike banks and insurance companies, are neither engaged in core financial intermediation activities as principal nor subject to consolidated regulatory capital requirements.

Accordingly, PNC believes that the Agencies should define a "financial institution" for purposes of the Financial Entity Deductions as:

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[10] See Basel III Consultative Document at § 101.

[11] For example, the Agencies' proposed definition of a "financial institution" would not include entities that are engaged—or even predominately engaged—in a number of activities that the Agencies have concluded are financial or part of, or incidental to, the business of banking, including (i) financial data processing activities, (ii) finder activities; and (iv) financial-related management consulting services. See 12 C.F.R. § 5.34(e)(v)(F), (R) and (Z) (OCC); 12 C.F.R. § 225.28(b)(9) and (14).

- Any of the following types of entities, each of which is subject to consolidated prudential regulatory capital requirements: a depository institution, a bank holding company, a savings and loan holding company, a foreign bank, a nonbank financial company supervised by the Federal Reserve under Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), a credit union, an insurance company, a securities firm,[12] or a financial market utility designated by the Financial Stability Oversight Council ("FSOC");[13] and

- Any other company that is predominately engaged as principal in (i) making loans (including leases that are the functional equivalent of an extension of credit), (ii) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability or death, or issuing annuities; or (iii) underwriting, dealing in, or making a market in securities or derivatives.

We believe this definition would fully achieve the goals of the Financial Entity Deductions in the Basel III Framework. The first prong of this definition ensures those unconsolidated investments that raise the "double counting" of regulatory capital concerns sought to be addressed by the Basel Committee are subject to the Financial Entity Deductions.

With respect to the second prong, principal activities pose a greater risk—both to an investing bank and to the financial system—than activities conducted as agent. The Agencies appear to have recognized this fact in the Proposed Rules by, for example, including within the proposed definition of a "financial institution" entities that are predominately engaged in underwriting insurance-type risks, issuing annuities or underwriting, dealing in, or making a market in securities—all of which are activities conducted as principal—but excluding from the definition entities predominately engaged in acting as an agent or broker in the sale of insurance,

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[12] A "securities firm" for these purposes should be defined in the same manner as under the Agencies' current generally applicable risk-based capital rules to mean (i) a U.S.-incorporated broker-dealer that is registered with the SEC and compliant with the SEC's net capital regulations (17 C.F.R. § 240.15c3(1)), or (2) a securities firm that is incorporated outside the United States and is subject to consolidated supervision and regulation (covering its subsidiaries, but not necessarily its parent organizations), including minimum capital requirements, comparable to that imposed on depository institutions in OECD countries. See, e.g., 12 C.F.R. Part 3, App. A.

[13] The Dodd-Frank Act generally defines a "financial market utility" (subject to certain exceptions) as an entity that manages or operates a multilateral system for the purpose of transferring, clearing or settling payments, securities, or other financial transactions among financial institutions or between financial institutions and the entity. The term generally would not include entities (such as joint ventures) that provide merchant processing services to business customers.

annuities or securities.[14] For similar reasons, we believe application of the Financial Entity Deductions (beyond those entities subject to consolidated regulatory capital requirements) should be limited to entities that are predominately engaged in the type of core financial intermediation activities that are conducted as principal by banks, insurance companies and broker-dealers.[15] Including firms engaged in core financial intermediation activities as principal would also ensure that unconsolidated investments in unregulated "shadow banking" firms engaged in such activities (such as independent mortgage lenders) are subject to the Financial Entity deductions.

We recognize that unconsolidated investments in other types of entities engaged in financial activities (such as entities predominately engaged in investment or financial advisory, financial data processing, or insurance or securities brokerage activities) pose some risk to the investing bank and that banks should hold prudent capital against the risk of these investments. In our view, the strengthened risk-weight framework for equity investments (including unconsolidated equity investments) under the Proposed Rules effectively addresses the more limited risk of these other unconsolidated investments. Specifically, as under Basel II currently, the Simple Risk Weight Approach ("SRWA") in the Advanced Approaches NPR requires that an advanced approaches bank apply a 300% risk weight to publicly traded equity investments and a 400% risk weight to non-publicly traded equity investments that exceed a non-significant threshold and are not subject to the Financial Entity Deductions.[16] Importantly, the Standardized Approach NPR would incorporate this same SRWA framework—and its 300% and 400% risk weights for public and non-public equity investments—into the general risk-based capital rules, thereby ensuring that these substantial risk weights will apply to all banks and not just advanced approaches banks.[17]

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[14] See Proposed Rules at § 2 (definition of a "financial institution").

[15] We discuss in Part I.A.3 below the proper test for determining whether a company is "predominately engaged" in an activity.

[16] See Proposed Rules at § 152(b)(5) and (6); 12 C.F.R. part 225, Appendix G, § 52(b)(3) and (4). Under the SRWA, a limited amount of "non-significant" publicly traded and non-publicly traded equity exposures may, subject to certain conditions and rules of priority, receive a 100% risk weight to the extent such exposures, when combined with other eligible "non-significant" equity exposures, do not exceed 10% of the organization's Tier 1 plus Tier 2 capital. See Proposed § 152(b)(3)(iii); 12 C.F.R. part 225, App. G at § 52(b)(3)(iii). Instead of using the SRWA, an advanced approaches bank may, with agency approval, use an Internal Models Approach ("IMA") to determine the required regulatory capital for equity investments that are not subject to the Financial Entity Deductions. The requirement for agency approval of a bank's IMA should ensure that a bank using the IMA is holding sufficient capital with respect to its equity investments.

[17] See Proposed Rules at § 52. Under the framework described above, Volcker Rule "covered funds" generally would not be considered a "financial institution." As explained in greater detail in the TCH/ASF Comment Letter and the ABA/SIFMA/FSR Comment Letter, Congress in the

2. Financial Entity Deductions Should Not Apply to Firms Engaged in Providing Discretionary or Non-Discretionary Investment or Financial Advice (Basel III NPR, Q. 32)

As noted above, the Proposed Rules would not apply the Financial Entity Deductions to unconsolidated investments in entities that are predominately or significantly engaged in "investment or financial advisory activities" (referred to herein as "investment advisory firms").[18] PNC strongly supports the Agencies' decision to exclude investments in investment advisory firms from the Financial Entity Deductions. Consistent with Agency precedent, we believe that the Agencies should clarify that "investment or financial advisory activities" include providing both discretionary and non-discretionary investment or financial advice to customers. We discuss below why excluding investment advisory firms, defined in this manner, from the Financial Entity Deductions is fully consistent with the Basel III Framework and is appropriate in light of the limited risk associated with the agency services provided by investment advisory firms.

Although the Proposed Rules do not define the phrase "investment or financial advisory activities," the Agencies have interpreted essentially these same terms to include providing both discretionary and non-discretionary investment or financial advice to clients, including registered investment companies. Specifically, the Federal Reserve's Regulation Y, which identifies the types of nonbanking activities permissible for bank holding companies, provides that "financial and investment advisory activities"—essentially the same term as used in the Basel III NPR—includes a broad range of advisory services provided as agent on behalf of customers.[19] These activities include, among other things—

- Providing discretionary or non-discretionary investment advice to customers, including registered investment companies;
- Furnishing general economic information and advice;
- Providing advice in connection with mergers, acquisitions, and other strategic transactions; and

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Volcker Rule indicated that a capital deduction is appropriate only for one type of "covered fund"—those organized and offered under section 13(d)(1)(G) of the Volcker Rule (12 U.S.C. § 1852(d)(1)(G)). For the reasons discussed in those letters, we believe that any deduction for investments in covered funds should (i) be limited to investments made under section 13(d)(1)(G) and (ii) should not apply during the Volcker Rule's conformance period. See TCH/ASF Comment Letter at 27-28; ABA/SIFMA/FSR Comment Letter at A-26.

[18] See Basel III NPR at § 2 (definition of "financial institution" paragraph (1)(v)(D)).

[19] See 12 C.F.R. § 225.28(b)(6).

- Providing information, statistical forecasting, and advice with respect to foreign exchange and derivative transactions.[20]

The OCC's regulations likewise authorize operating subsidiaries of a national bank to serve as an "investment adviser." Importantly, the OCC's regulations provide that the permissible services provided by an "investment adviser" include serving as "an adviser with investment discretion . . . to governmental entities or instrumentalities, businesses or individuals, including advising registered investment companies."[21]

We strongly believe that the phrase "investment or financial advisory activities" should be interpreted in the same manner for purposes of the Financial Entity Deductions. We believe interpreting the phrase in this way to include both discretionary and non-discretionary investment and financial advice is not only important to maintain regulatory consistency, but also would be fully consistent with the purposes of Financial Entity Deductions and the limited risk posed by investments in investment advisory firms. In this regard, unlike banks, insurance companies and securities firms, investment advisory firms typically are not subject to consolidated regulatory capital requirements. Thus, investments in investment advisory firms do not present the risk of the "double counting" of regulatory capital that the Financial Entity Limitations were designed to address.

Moreover, investment advisory firms present less risk—both to an investing bank and the financial system—than banks, insurance companies or securities firms. In particular, unlike banks, insurance companies or securities firms that act as principal and use their own balance sheet to lend, indemnify others or deal in financial instruments, the role of an investment adviser in a transaction is to act as an agent on behalf of its customers. It is an investment adviser's clients that beneficially own the investments managed by the adviser. Thus, the risk of loss on these assets resides with third parties, not with the investment adviser, regardless of whether advice is provided on a discretionary or non-discretionary basis.[22]

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[20] See 12 C.F.R. § 225.28(b)(6) and § 225.125; Lloyds TSB Group plc, 84 Fed. Res. Bull. 116 (Feb. 1998).

[21] See 12 C.F.R. § 5.34(e)(v)(I); see also 12 C.F.R. § 9.101 ("'investment adviser' generally means . . . provid[ing] advice or recommendations concerning the purchase or sale of specific securities . . . including acting as investment adviser to a mutual fund").

[22] In this regard, we agree that, to the extent a firm itself invests as principal in a fund to which it provides advisory services, such investment activities as principal should not be considered "investment or financial advisory services." Interpreting the phrase in this manner again would be consistent with Agency precedent. For example, while bank holding companies are authorized to make investments in funds that they advise (subject to certain conditions and limitations), it is not the authority in section 225.28(b)(6) of Regulation Y (12 C.F.R. § 225.28(b)(6)) to serve as a "financial or investment advisor" that permits such investments, but

In addition, investment advisory firms typically use third-party custodians to hold client assets and do not have physical control or direct access to a client's assets. These custodial arrangements not only reduce the risk associated with an investment in an investment advisory firm, they also facilitate the resolution of a failed investment advisory firm, as the firm's advisory arrangements can be transferred to a new firm with the clients' assets remaining at the custodian.

Investment advisory firms also tend to be less leveraged than banks, insurance companies and securities firms and, therefore, less risky. By definition, firms that have a high ratio of total consolidated assets to total equity—their leverage ratio—are riskier than companies with lower ratios. The FSOC's final rule implementing its authority to designate nonbank financial companies as systemically important recognizes this fact. In that rule, the FSOC determined that a leverage ratio in excess of 15 may, in combination with other factors, indicate that a firm poses potential systemic risk.[23] In comparison, investment advisory firms tend to have low leverage ratios. For example, according to a May 2012 Standard and Poor's report, BlackRock had a leverage ratio of only 2.4; Invesco Holding Company, Ltd. had a leverage ratio of only 2.1; Franklin Resources had a leverage ratio of only 1.5; and Legg Mason Inc. had a leverage ratio of only 1.5.[24]

We believe these facts demonstrate that investment advisory firms do not pose the type of risks, either to an investing bank or to the financial system, that would support application of the Financial Entity Deductions to unconsolidated investments in such firms. These same facts may help explain why the FSOC has indicated publicly that it is still analyzing whether, or how, investment advisory firms may present systemic risks.[25] We believe that it would be premature, at best, to apply the Financial Entity Deductions to unconsolidated investments in investment advisory firms based on potential interconnectedness or systemic risk concerns given that the

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other authority in Regulation Y. See, e.g., 12 C.F.R. § 225.22(d)(5) (permitting non-controlling investments of up to 5% of the voting securities of any company); 12 C.F.R. § 225.22(d)(6) (permitting investments in investment companies that limit their investments to non-controlling positions of 5% or less of the voting securities of any company); and 12 C.F.R. § 225.170 (authorizing merchant banking investments).

[23] See 77 Fed. Reg. 21637, 21661 (Apr. 11, 2012). For these purposes, leverage is defined as total consolidated assets (excluding separate accounts) to total equity. As discussed in Part I.A.3 below, we believe that non-guaranteed separate account assets also should be excluded for purposes of determining whether a company is "predominately engaged" in an activity for purposes of the Financial Entity Deductions.

[24] See Standard & Poor's, *New Regulatory Rules Likely Will Have A Limited Impact On U.S. Nonbank Financial Company Ratings*, p. 5 (May 2012).

[25] See 77 Fed. Reg. 21637, 21645 (Apr. 11, 2012).

FSOC has not yet determined whether or how such firms may in fact present risks to the U.S. financial system.

We recognize, however, that an unconsolidated investment in an investment advisory firm could pose heightened risk if the firm is highly leveraged and that a firm's leverage ratio may change over time. Accordingly, if the Agencies are concerned that excluding all unconsolidated investments in investment advisory firms may permit some investments in highly leveraged firms to avoid the Financial Entity Deductions, we believe that the Agencies could address this concern by excluding only those investment advisory firms that have (i) a leverage ratio (as defined by the FSOC) of 10 or less, and (ii) an aggregate amount of extensions of credit and unfunded loan commitments outstanding of less than 100% of the firm's total equity. We note that this 10-to-1 leverage ratio limit is significantly more stringent than the 15-to-1 leverage ratio established by the FSOC for Stage 1 review purposes. Moreover, the separate limit on extensions of credit and unfunded loan commitments would ensure that an exempt investment advisory firm also is not highly leveraged on a loan-to-equity basis.

In any event, as noted above, PNC and other banks would continue to be required to hold prudent levels of capital for unconsolidated investments in investment advisory firms that are not subject to the Financial Entity Deductions. Under the SRWA in both the Advanced Approaches NPR and the Standardized Approach NPR, banks generally would be required to assign a 300% or 400% risk weight to any publicly traded or non-publicly traded, respectively, unconsolidated investment in an investment advisory firm that is not subject to the Financial Entity Deductions and that exceed the Agencies' proposed non-significant threshold.[26] We believe these risk weights are more than adequate to addresses the limited risk of these investments.

3. "Predominately Engaged" Test Should be Revised to Account for the Special Nature of Separate Account Assets and Related Securities Lending Collateral (Basel III NPR, Q. 32)

Under the Basel III NPR, a company is considered to be "predominately engaged" in an activity or activities if (i) the company derived 85 percent or more of its consolidated annual gross revenues in either of the two most recent calendar years from such activities (the "85 percent revenue test"), or (ii) 85 percent or more of the company's consolidated total assets as of the end of either of the two most recent calendar years were related to such activities (the "85 percent asset test).[27] We believe that these revenue and asset thresholds should remain 85 percent as proposed (rather than a lower threshold). An 85 percent threshold is consistent with the threshold established by the Dodd-Frank Act for purposes of determining whether a

[26] See Proposed Rules at § 52 and § 152.

[27] See Proposed Rules at § 2 (paragraph (2) of the "financial institution" definition).

company is "predominately engaged" in financial activities,[28] and should help ensure that the Financial Entity Deductions properly are applied to firms whose business activities are clearly focused on those financial activities (e.g., lending, insurance underwriting or securities dealing) that warrant application of the deductions in the first place.

We believe, however, that the assets of non-guaranteed separate accounts, as well as any securities lending collateral received in connection with securities lending transactions conducted for such accounts, should be excluded for purposes of determining whether a company meets the 85 percent asset test. As the Agencies have recognized in the Proposed Rules, a separate account is a legally segregated pool of assets that is owned and held by an insurance company separate from the insurance company's general account assets and, importantly, are not subject to the general claims of creditors of the insurance company.[29] In addition, under GAAP, the amount of a company's separate account assets is offset on the company's financial statements by an equal amount of separate account liabilities. Moreover, in the case of a non-guaranteed separate account, all gains or losses on the investments made by the separate account must be passed on to the contract holder and are not borne by the insurance company, the insurance company does not provide any guarantee or a minimum account value or return, and the insurance company is not required to hold reserves against the separate account assets pursuant to its contractual obligations on the associated policies.[30]

Because separate account assets are not available to a company's general creditors, pose no principal risk to the company offering the separate account,[31] and are offset by an equal amount of separate account liabilities, we believe such assets are clearly distinguishable from the general assets of a company and should be excluded for purposes of determining whether a company meets the 85 percent asset test. Indeed, including non-guaranteed separate account assets in a company's assets for purposes of the 85 percent asset test would, in our view, inappropriately skew the analysis of a firm's assets from an economic perspective. We note that, for similar reasons, the FSOC has determined that all separate account assets (whether guaranteed or non-guaranteed) should be excluded for purposes of determining whether a nonbank financial company exceeds the leverage ratio or the short-term debt ratio established by the FSOC as Stage 1 screens for evaluating whether a nonbank financial company may pose a threat to U.S. financial stability.[32] Importantly, under our proposal, the revenues derived by a

[28] See 12 U.S.C. § 5311(a)(6).

[29] See Standardized Approach NPR at 52928-29.

[30] See id.

[31] In fact, the Agencies have proposed assigning a zero percent risk weight to non-guaranteed separate account assets precisely because all of the losses on such assets are passed on to the contract holders. See id.

[32] In particular, under the Stage 1 guidelines adopted by the FSOC, separate account assets are expressly excluded from total consolidated assets in determining whether a nonbank financial

company from providing separate accounts would continue to be included in the company's consolidated revenues for purposes of determining whether the company met the 85 percent revenue test. Including such revenue for purposes of the 85 percent revenue test would continue to ensure that a company's separate account activities are taken into account in an appropriate way in determining whether the company is predominately engaged in insurance activities.

A company also may facilitate securities lending arrangements involving the securities held by a separate account. Under GAAP, these transactions may result in the company recording the collateral received under the securities lending arrangements as its own asset. However, even in such circumstances, the assets recorded on the company's financial statements are offset by an equal amount of liabilities reflecting the company's obligation to return the collateral. Accordingly, we believe that the collateral held pursuant to such securities lending arrangements conducted with respect to separate accounts also should be excluded from a company's assets for purposes of the 85 percent asset test. Again, under this proposal, the revenue from such activities would continue to be included in applying the 85 percent revenue test.

4. <u>The Look-Through Requirement for "Indirect" Unconsolidated Investments in Financial Institutions Should be Modified to Eliminate the Potential For Double-Counting and Reduce Operational Difficulties</u> (Basel III NPR, Q. 33)

Under the Proposed Rules, a bank would have to apply the Financial Entity Deductions not only to direct unconsolidated investments in a financial institution, but also to "indirect" unconsolidated investments in financial institutions. The Basel III NPR provides an example of such an "indirect" investment as an "investment in the capital of an unconsolidated entity that has an investment in the capital of an unconsolidated financial institution."[33] We are concerned that application of the Financial Entity Deductions to "indirect" investments in the manner suggested by the Proposed Rules would not only lead to the double-counting of certain investments, but also would be highly difficult, if not impossible, for banks to implement as an operational matter.

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company (i) has a leverage ratio in excess of 15 to 1; or (ii) a short-term debt ratio (<u>i.e.</u>, a ratio of total short-term debt outstanding to total consolidated assets) of 10 percent or greater. <u>See</u> 77 Fed. Reg. 21637, 21661 (Apr. 11, 2012). While the FSOC's Stage 1 guidelines do not exclude separate account assets for purposes of determining whether a nonbank financial company has more than $50 billion or more in total consolidated assets (another Stage 1 screen), we believe that it is not logically consistent to exclude separate account assets from a firm's consolidated total assets for purposes of assessing a company's leverage ratio and short-term debt ratio, but include such assets in a firm's consolidated total assets for purposes of an asset test.

[33] <u>See</u> Basel III NPR at 52821.

Specifically, where a bank has an unconsolidated investment in the capital stock of a financial institution ("Financial Institution X"), such investment is already subject to the Financial Entity Deductions. In such circumstances, requiring a bank to separately apply the Financial Entity Deductions to any unconsolidated investment in another financial institution that Financial Institution X may hold would effectively result in an inappropriate "double deduction." This is because the value of Financial Institution X's unconsolidated investment in the other financial institution would already be reflected in the value of the bank's unconsolidated investment in Financial Institution X, which, as noted above, would already have been subject to the Financial Entity Deductions. For this reason, we request that the Agencies clarify in the final rules that, if an investment in a financial institution is subject to the Financial Entity Deductions, then any unconsolidated investment in a financial institution held by such financial institution is not subject to the Financial Entity Deductions.

More broadly, it likely will be difficult, if not impossible, for banks to determine whether an entity in which the bank has a direct *or indirect* investment, or to which the bank has a synthetic exposure, itself has an unconsolidated investment in a financial institution.[34] The Agencies appear to have recognized this difficulty in the Basel III NPR by expressly soliciting comment on the proper scope of indirect exposures to unconsolidated investments in financial institutions for purposes of the Proposed Rules.[35] We support the recommendations made in both the TCH/ASF Comment Letter and the ABA/SIFMA/FSR Comment Letter with respect to these "look through" requirements. We note, moreover, that the Basel Committee recently indicated that "an indirect holding of capital arises when a bank invests in an unconsolidated intermediate entity *to gain an exposure to the capital of another financial institution,*"[36] and that the European Union has modified the manner in which the Basel III look-through requirements are applied to address the numerous operational problems that it creates.[37] Thus, we believe the Agencies have significant flexibility to implement a workable framework consistent with the recommendations made in the comment letters referenced above.

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[34] For example, taken to its logical extreme, the Proposed Rules would require a bank to analyze and assess whether any company in which the bank has an investment, and any company in which any such company has a direct or indirect investment, has an unconsolidated investment in a financial institution.

[35] See Basel III NPR at 52821, Q. 33.

[36] See Basel Committee, *Basel III regulatory consistency assessment (Level 2) Preliminary Report: European Union* at 25 (Oct. 2012), available at http://www.bis.org/bcbs/implementation/l2_eu.pdf.

[37] See id.

B. AOCI Filter Should be Retained for AFS Debt Securities Whose Fair Value Changes are Predominately Attributable to Changes in Interest Rates (Basel III NPR, Q. 16 and Q. 17)

Under the current risk-based capital rules, unrealized gains and losses, other than losses that result from other-than-temporary credit impairments, on available for sale ("AFS") debt securities are not included in regulatory capital, although these gains and losses are recorded as accumulated other comprehensive income/loss ("AOCI") under GAAP. The Proposed Rules would remove this AOCI filter for all AFS debt securities, thereby including all gains or losses on AFS debt securities as an adjustment to the CET1 of banks. The Agencies, however, have specifically requested comment on whether the AOCI filter should be retained for AFS debt securities for which any changes in fair value are predominately attributable to fluctuations in a benchmark interest rate.[38]

PNC strongly believes that the AOCI filter should be retained for high-quality AFS debt securities for which any unrealized fair value gains or losses are predominately attributable to changes in interest rates, and not changes in credit risk.[39] We believe such instruments should include, at a minimum, (i) debt obligations of the U.S. Treasury, a U.S. agency or a GSE (including Fannie Mae and Freddie Mac) and (ii) obligations guaranteed as to principal and interest by a U.S. agency or GSE, including Fannie Mae and Freddie Mac (collectively referred to as "Eligible AFS Debt Obligations"). We believe retention of the AOCI filter for Eligible AFS Debt Securities is necessary and appropriate for several reasons.

First, any changes in the fair value of such instruments are predominately driven by changes in benchmark interest rates, rather than changes in underlying credit risk. In this regard, U.S. Treasury obligations continue to serve as the benchmark for fixed-income obligations worldwide because they are perceived to have no comparative credit risk. Trading prices for obligations of U.S. agencies, in turn, are highly correlated to trading prices of U.S. Treasury securities with comparable maturities, with any difference largely occurring as result of differences in the size of the relevant markets. Similarly, as the data included in Annex 3 and Annex 4 of the TCH/ASF Comment Letter demonstrates, trading prices for GSE debt securities, as well as those for Ginnie Mae- and GSE-guaranteed MBS, are highly correlated with trading prices for U.S. Treasury obligations and have traded at consistent spreads to U.S. Treasury obligations over extended periods.[40]

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[38] See Basel III NPR at 52812, Q. 17.

[39] That is, both losses and gains on these securities would continue to be excluded from regulatory capital.

[40] See TCH/ASF Comment Letter at Annex 3 and Annex 4. Moreover, as the Agencies recognized in the Standardized Approach NPR, Fannie Mae and Freddie Mac currently operate under a conservatorship administered by the Federal Housing Finance Agency and receive

Second, continuing the AOCI filter for Eligible AFS Debt Securities is necessary to avoid disrupting sound asset-liability management practices, as well as asymmetric and uneconomic effects on regulatory capital. Consistent with prudent risk management principles, banks hold substantial quantities of Eligible Debt Securities in their AFS portfolios to hedge the interest rate risk that arises from their fixed-rate deposits and other fixed-rate liabilities. Unlike AFS debt securities, however, fixed-rate deposits and many other fixed-rate liabilities are not fair valued for accounting purposes. Thus, including changes in the fair value of Eligible AFS Debt Securities in regulatory capital, but not the offsetting changes in the economic value of the fixed-rate liabilities that such Eligible AFS Debt Securities are held to hedge, creates an asymmetry in how interest rate changes are reflected in a bank's regulatory capital—with changes on the asset side reflected in regulatory capital, but those on the liability side excluded. Accordingly, removing the AOCI filter for Eligible AFS Debt Securities would present investors with a skewed view of the actual economic impact of interest rate changes on a bank's balance sheet and regulatory capital.

It is true that a bank could seek to limit this asymmetric effect by reducing the average maturity of the Eligible AFS Debt Securities that it holds for hedging purposes or by using different types of instruments—such as interest rate swaps, caps or floors—to hedge the interest rate risk from its fixed-rate deposits and other liabilities. However, such actions may not be as successful or cost-effective in hedging the bank's interest rate risk and, thus, impair the ability of banks to prudently manage interest rate risk. Moreover, encouraging banks to shift interest rate hedging strategies to either shorter duration securities or OTC derivatives could have adverse effects on the financial markets and the financial system. For example, forcing banks to shorten the maturities of their AFS securities portfolios could reduce liquidity for longer duration Eligible AFS Debt Securities, including 30-year GSE-guaranteed mortgage-backed securities and debentures. In addition, encouraging banks to switch their hedge holdings from debt obligations to OTC derivative instruments could, counter to the goals of Basel III, result in significant increases in counterparty credit risk and interconnectivity within the financial system.

Third, maintaining the AOCI Filter for Eligible AFS Debt Securities is necessary to ensure that the Proposed Rules do not conflict with the Basel III Liquidity Coverage Ratio ("LCR"). As a result of the LCR, banks will be required to hold substantial quantities of highly liquid assets. We believe that all Eligible AFS Debt Securities, including GSE-guaranteed mortgage-backed securities ("MBS"), should qualify as Level 1 assets for LCR purposes and that banks will rely predominately on Eligible AFS Debt Securities to satisfy the requirements of the

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capital support from the U.S. Treasury. See Standardized Approach NPR at 52896. We recognize that it may be appropriate for the Agencies to re-visit the treatment of Fannie Mae and Freddie Mac as GSEs once the conservatorships for such organizations are terminated and their ultimate status becomes known.

LCR.[41] We do not believe that the regulatory capital ratios of a bank should be subject to artificial volatility as a result of its holdings of highly liquid assets that qualify without limit for purposes of satisfying the LCR.[42]

Fourth, the fact that banks have to maintain large portfolios of Eligible AFS Debt Securities—both for LCR and interest rate hedging purposes—means that such securities are not likely to be sold frequently. Thus, any fair value changes in such securities that result from interest rate movements will be transitory and likely not be realized by the bank. Indeed, an analysis conducted by Sandler O'Neill + Partners of all AFS securities held by U.S.-regulated banks indicates that, while unrealized gains and losses on such securities (as a percentage of the value of the AFS securities) varied from -2.0% to 1.4% between 1993 and 2011, net realized gains on such securities remained remarkably low and stable during this time period, varying from a high of 0.2% to a low of 0.0%.[43] The incidence of realized gains or losses on Eligible AFS Debt Securities likely will be even less as a result of the LCR. To the extent that banks need or desire additional funding based on their holdings of Eligible AFS Debt Securities prior to maturity, such securities can easily be used as collateral in the broad and deep securities financing markets for such securities. Removing the AOCI filter for Eligible AFS Debt Securities would, therefore, force the recognition in capital ratios of unrealized gains and losses that are unlikely ever to be realized and provide investors with capital ratios that are not truly reflective of the bank's risk.

Fifth, including unrealized gains and losses on Eligible AFS Debt Securities would introduce substantial and, for the reasons discussed above, unnecessary volatility into the regulatory capital ratios of banking organizations. In order to estimate the potential effect of interest rate changes on bank capital ratios that would occur if the AOCI filter for Eligible AFS Debt Securities was removed, PNC together with 13 other members of The Clearing House

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41 We note in this regard that the Federal Reserve's proposed liquidity rules under section 165 of the Dodd-Frank Act expressly include GSE-guaranteed mortgage-backed securities within the definition of "highly liquid assets." See 77 Fed. Reg. 594 (Jan. 5, 2012) (proposed 12 C.F.R. § 252.51(g)).

42 For this reason, if other assets in addition to Eligible AFS Debt Securities are determined to be Level 1 assets for purposes of the LCR, we believe that unrealized gains and losses on such assets also should be excluded from regulatory capital.

43 See Letter from Messrs. Price, Albertson, Chandonnet, Killian and Longino, Principals, Sandler O'Neill + Partners to The Honorable Thomas J. Curry, The Honorable Ben S. Bernanke and The Honorable Martin J. Gruenberg, dated September 6, 2012, *Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions and Prompt Corrective Action*, available at http://www.federalreserve.gov/SECRS/2012/September/20120917/R-1442/R-1442_090612_108296_324562014337_1.pdf.

Association individually calculated the impact on the institution's tier 1 common ("T1C") ratio if, as of June 30, 2012, the AOCI filter had been removed for such securities and there had been a 100, 200 or 300 basis point parallel upward shift in the yield curve. The analysis of the results compiled by The Clearing House Association demonstrates that removal of the AOCI filter for Eligible AFS Debt Securities would introduce significant volatility to the T1C ratios of large banks simply due to changes in interest rates. Specifically, the simple average impact on the T1C ratio across the 14 participating institutions would have been:

- A decrease of 32 basis points for a 100 basis point parallel upward shift (with individual institution results reportedly varying between decreases of 8 and 21 basis points);
- A decrease of 74 basis points for a 200 basis point parallel upward shift (with individual institution results reportedly varying between decreases of 23 and 135 basis points); and
- A decrease of 120 basis points for a 300 basis point parallel upward shift (with individual institution results reportedly varying between decreases of 46 and 214 basis points).[44]

In light of this potential volatility, the Proposed Rules, if implemented, would require banks to maintain a significant capital "buffer" above otherwise-mandated levels (including the capital conservation buffer and any applicable countercyclical buffer and G-SIB or D-SIB surcharge) simply to avoid interest rate-driven fair value changes on Eligible AFS Debt Securities from unexpectedly causing capital levels to fall below the thresholds at which limitations on capital distributions and discretionary bonus payments apply. We do not believe such a result is warranted or appropriate particularly given, as described above, (i) any changes in fair value of such securities are likely to result from interest rate changes, be temporary and remain unrealized, and (ii) inclusion of such fair value changes in regulatory capital would provide an inaccurate and incomplete view of the actual risks of a bank's balance sheet, would conflict with the LCR, and would impair sound and prudent asset-liability management activities.

[44] See TCH/ASF Comment Letter at p. 13-14.

C. <u>Minority Interest Limitations Should Not Apply to REIT Preferred Securities and Bank-Issued Additional Tier 1 and Tier 2 Capital</u>

Section 21 of the Proposed Rules places highly restrictive limitations on the amount of capital issued by a consolidated subsidiary to third party investors that may be included in the regulatory capital of the parent banking organization. As a general matter, these limits are based on the amount of capital held by the consolidated subsidiary relative to the amount of capital the subsidiary would have to hold in order to avoid any limitations on capital distributions and discretionary bonus payments under the capital conservation buffer. The amount of minority interest capital *excluded* from the parent's regulatory capital increases the greater the amount of "surplus" capital the consolidated subsidiary holds over the amount required under the capital conservation buffer.

1. <u>REIT Preferred Securities Should Not Be Subject to the Proposed Rules' Minority Interest Limitations in Light of Their Exchange Feature and Loss-Absorption Capacity</u> (Basel III NPR, Q. 27)

We do not believe it is appropriate or consistent with the Basel III Framework to apply the minority interest limitations in Section 21 of the Proposed Rules to REIT preferred securities that currently qualify as Tier 1 capital under the Agencies' general risk-based capital rules and that have the ability to issue a "consent" dividend ("Eligible REIT Preferred Securities").[45]

The Basel III NPR indicates that the limitations on minority interest in Section 21 of the Proposed Rules are due to concerns that "capital issued by consolidated subsidiaries . . . does not always absorb losses at the consolidated level."[46] However, as the Agencies recognize in the Basel III NPR, REIT preferred securities include specific terms designed to ensure that the securities *are* available to absorb losses at the parent banking organization in the event the parent organization experiences financial distress. In particular, REIT preferred securities must include a feature that provides for the securities to be automatically exchanged into non-cumulative perpetual preferred stock of the parent organization, at the option of the parent organization's primary Federal banking agency, if (i) the parent is undercapitalized under the agency's prompt corrective action regulations; (ii) the parent organization is placed into conservatorship or receivership; or (iii) the agency, in its sole discretion, anticipates that the parent organization will become undercapitalized in the near term.[47]

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[45] A consent dividend is a dividend that (i) is not actually paid to shareholders, (ii) is kept as part of the REIT's retained earnings, and (iii) the shareholders have consented to treat as if paid in cash for tax purposes.

[46] <u>See</u> Basel III NPR at 52815-16.

[47] <u>See</u> OCC Corporate Decision No. 97-109 (December 1997); Comptroller's Licensing Manual, Capital and Dividends, p. 13 (Nov. 2007).

These terms ensure that REIT preferred securities are available to "absorb losses at the consolidated level" in times of financial stress. Moreover, the loss-absorption capacity of REIT preferred fact is known to, and recognized by, the marketplace and investors. In this regard, in our experience, the rating of REIT preferred securities generally is the same as the rating of the perpetual preferred stock of the consolidated entity. For these reasons, we believe that exempting Eligible REIT Preferred Securities from the minority interest limitations in Section 21 of the Proposed Rules is not only appropriate, but fully consistent with the Agencies' goals and the Basel III Framework.

Exempting Eligible REIT Preferred Securities from the minority interest rules also is important in order to ensure that U.S. banks continue to have a viable option for raising Additional Tier 1 capital. In light of the requirement in the Proposed Rules that Additional Tier 1 elements have a perpetual life and the elimination of the Tier 1 capital treatment of trust preferred securities, REIT preferred securities and similar securities are the only currently available form of preferred stock that qualifies as tax-deductible under the Internal Revenue Code of 1986. Applying the minority interest rules to REIT preferred securities, however, would as a practical matter eliminate REIT preferred securities as an economically viable capital instrument for banks. This is because the rules likely would prohibit a bank from including all but a de minimis percentage of REIT preferred securities in the bank's Tier 1 capital or even Tier 2 Capital.[48] Such a result would place U.S. banking organizations at a comparative disadvantage *vis-à-vis* institutions in foreign jurisdictions whose tax regimes permit tax-advantaged Tier 1 instruments, and effectively convert the 7.0 percent CET1 threshold for U.S. banks to an 8.5 percent CET1 requirement (given the lack of economically viable Additional Tier 1 instruments at the bank level).

We understand that during the financial crisis the Agencies experienced certain operational issues in connection with the exchange of REIT preferred securities issued by individual banks and the associated transfer of the underlying REIT's assets. We believe that these operational issues were primarily a result of a lack of clarity in the REIT preferred's governing documents concerning the required transfer of the REIT's assets to the bank subsidiary, as well as the late trigger of the REIT preferred's exchange feature in the particular instances. We believe the documentation associated with PNC's REIT preferred securities clearly provide for the relevant REIT assets to be conveyed to PNC Bank upon an exchange event (even when the exchange is into preferred stock of PNC). Moreover, to the extent the Agencies are concerned that similar operational issues might reoccur in the future, we believe the appropriate way to address those concerns would be by modifying, on a forward-looking basis, the triggers and terms governing REIT preferred securities. For example, the Agencies could

[48] Of the Eligible REIT Preferred Securities that PNC currently has outstanding, we estimate that less than 4% would qualify as Additional Tier 1 capital of PNC and less than 1% would qualify as Tier 2 capital under the proposed minority interest rules.

require that newly-issued REIT preferred securities (i) provide for an exchange into the non-cumulative perpetual preferred stock of the parent at a lower level of stress than required currently (such as, for example, if any of the banking organization's capital levels fell to within 0.25 basis points of the lower bound of the "adequately capitalized" range); and (ii) have clear and enforceable language concerning the proper resolution of a REIT's assets in the event of an exchange.[49] As a matter of fairness, however, existing REIT Preferred Securities should be grandfathered from any such new requirements and exempted from the minority interest rules for the reasons discussed above.

2. Bank-Issued Additional Tier 1 and Tier 2 Capital is Uniquely Positioned to Protect Depositors and Should not be Subject to the Minority Interest Limitations (Basel III NPR, Q. 26)

We also believe that the proposed minority interest rules should not apply to Additional Tier 1 and Tier 2 capital instruments (including subordinated debt) issued by bank subsidiaries of U.S. banking organizations. The primary goal of the supervision and regulation of banking organizations is to protect the safety and soundness of banks, and capital issued directly by a bank is optimally placed to absorb losses at the bank and protect the FDIC Deposit Insurance Fund against loss. The proposed minority interest rules, however, would create a disincentive for banks within a holding company structure to issue capital instruments directly to the public, forcing banks to rely more heavily on their parent holding companies for capital and funding and raising the cost of capital to banking organizations and banks.[50]

In addition, because the amount of "surplus" minority interest that is excluded from regulatory capital increases as the bank subsidiary's capital levels exceed the capital conservation buffer level, the minority interest provisions of the Proposed Rules actually discourage a banks subsidiary with outside capital investors from maintaining a prudent capital buffer *above* the effective regulatory minimum levels. We note that the European Union has proposed to implement Basel III's minority interest provisions in a way that diverges from the Basel III Framework due to similar concerns that the Basel III Framework, as adopted, would lead to a reduction in the capital levels held by subsidiaries.[51]

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[49] Absent these changes, Eligible REIT Preferred Securities should, at a minimum, be permitted to count as Tier 2 capital at the parent banking organization without application of the minority interest rules. Even if an exchange occurs only shortly before the relevant parent banking organization fails, the organization's perpetual preferred stock issued in the exchange is clearly available to absorb losses and would do so before other instruments that count as Tier 2 capital under the Proposed Rules, such as subordinated debt issued by the parent organization.

[50] Subordinated debt issued by bank subsidiaries of a bank holding company typically bears a lower rate than similar debt issued by the bank's holding company.

[51] See Basel Committee, *Basel III regulatory consistency assessment (Level 2) Preliminary report: European Union*, at p. 24 (October 2012).

Strictly applying the minority interest rules in the Basel III Framework to capital issued by U.S. banks also would have a disparate impact on U.S. banking organizations because of the unique structure of the banking industry in the United States. In most foreign countries, it is the foreign bank that is the top-tier entity in the organizational structure and, thus, the minority interest rules will not result in a haircut on, or act as a disincentive to the issuance of, capital by the foreign bank. In the United States, however, the vast majority of banking organizations are structured so that the top-tier entity is a bank holding company. Thus, without modifications, application of the Basel III minority interest rules to U.S. banking organizations would have a much more severe impact on bank-issued capital than in other countries.

For all of the foregoing reasons, we believe that the Agencies should modify the Proposed Rules to exclude bank-issued Additional Tier 1 and Tier 2 capital from the minority interest limitations in Section 21. We believe that such a modification of the Proposed Rules would be consistent with the purposes and goals of bank supervision—the protection of banks and the FDIC Deposit Insurance Fund—and is appropriate in light of the unique structure of the U.S. banking system.

If, nevertheless, the Agencies decide not to exclude bank-issued capital from the minority interest rules, then we believe the Agencies should, at a minimum, modify the manner in which "excess" minority interest is calculated with respect to bank subsidiaries to mitigate the disincentive that the Proposed Rules create for a bank subsidiary to hold prudent capital buffers above the effective regulatory minimums. One way of doing so would be to provide that a bank subsidiary will be deemed to have "surplus" capital for purposes of the minority interest rules in Section 21 only if its capital exceeds the capital conservation buffer level by a specified amount (e.g., 200 basis points). An alternative way of achieving this goal would be to calculate the "surplus" capital of a bank subsidiary independently for each component of capital. To illustrate, assume a bank subsidiary prudently decides to maintain its capital levels at 200 basis points above the conservation buffer levels for each capital component (i.e., it seeks to maintain 9.0% CET1, 10.5% Tier 1 and 12.5% total capital)[52] and it does so by having 2% of "surplus" CET1, the highest quality of capital. As a result, the amount of the bank's Additional Tier 1 and Tier 2 capital would be 1.5% and 2.0%. Looking at Additional Tier 1 and Tier 2 independently, the bank has no "surplus" Additional Tier 1 or Tier 2 capital, as the amount of Additional Tier 1 and Tier 2 held is precisely the amount required by the Proposed Rules' *minimum* capital requirements.[53] Applying this type of methodology to the minority interest rules for bank

[52] For purposes of this hypothetical, we have assumed that the bank subsidiary is not subject to any additional capital surcharge or countercyclical capital buffer.

[53] That is, the minimum Tier 1 level is 6.0%, which is 1.5% more than the CET1 minimum level of 4.5%, and the minimum total capital level is 8.5%, which is 2.0% more than the minimum Tier 1 level of 6.0%.

subsidiaries, thus, is fully consistent with the actual amount of capital components issued by the relevant bank. Moreover, because banks are highly unlikely to issue CET1 to outside investors, it also largely removes the disincentive for banks to hold capital levels above the capital conservation buffer levels.

D. Goodwill Embedded in the Carrying Value of a Significant Investment in an Unconsolidated Financial Institution

Section 22(a)(1) of the Proposed Rules requires that a banking organization deduct from its CET1 any goodwill (net of associated DTLs), as well any "goodwill embedded in the valuation of a significant investment in the capital of an unconsolidated financial institution in the form of common stock."[54] As the Basel Committee and the Agencies have noted, when a banking organization accounts for an investment in an unconsolidated financial institution under the equity method of accounting, the carrying value of the banking organization's own common stock investment in the financial institution may include an amount of "embedded" goodwill.[55]

We believe, and respectfully request that the Agencies confirm, that where a banking organization has an unconsolidated investment in a financial institution that is accounted for under the equity method of accounting under GAAP, it is the amount of goodwill (if any) that is included in the carrying value of the banking organization's common stock investment in such financial institution and reflected on the banking organization's GAAP consolidated financial statements that is to be deducted from the banking organization's CET1 under § 22(a)(1). We believe this result is appropriate, as such amount (i.e., the goodwill amount reflected in the carrying value of the banking organization's common stock investment in the financial institution) is the only amount of goodwill associated with the financial institution that is reflected on the financial statements of the banking organization and, thus, may result in a financial loss to the banking organization if impaired or written down. In order to provide additional clarity to banking organizations on this point, we respectfully request that the Agencies revise § 22(a)(1) to read as follows (new language underlined):

> "(1) Goodwill, net of associated deferred tax liabilities (DTLs), in accordance with paragraph (e) of this section, and goodwill that is embedded in the valuation of a significant investment in the capital stock of an unconsolidated financial institution in the

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[54] See Proposed Rules at § 22(a)(1). Any goodwill embedded in the valuation of a significant investment in the capital of an unconsolidated financial institution in the form of common stock that is deducted under § 22(a)(1) may be excluded from the amount of the investment subject to the 10 percent and 15 percent threshold deductions. Id. at § 22(d)(1)(i), n. 13.

[55] See Basel Committee, *Basel III definition of capital—Frequently asked questions* (October 2011), FAQ No. 1 under ¶¶ 67-68 (Goodwill and other intangibles); Basel III NPR at 52818.

form of common stock and reflected in the consolidated financial statements of the [BANK], in accordance with paragraph (d) of this section."

We understand, moreover, that the amount of goodwill embedded in the carrying value of a banking organization's common stock investment in a significant investment in an unconsolidated financial institution accounted for under the equity method of accounting should be calculated based on (i) the amount of such goodwill embedded in the carrying value of the banking organization's common stock investment at the time the banking organization's investment becomes subject to the equity method (i.e., at acquisition or deconsolidation); less (ii) any subsequent impairment losses to this goodwill amount reflected in the banking organization's common stock investment, both as determined in accordance with applicable accounting standards. We respectfully request that the Agencies confirm this understanding.

E. Netting of Deferred Tax Liabilities

Section 22(c)(1) of the Proposed Rules provide that a bank may (but is not required to) net DTLs against assets that are subject to a deduction from regulatory capital under § 22 if certain conditions are met. These conditions generally are (i) the DTL is associated with the asset; (ii) the DTL would be extinguished if the associated asset becomes impaired or is derecognized under GAAP; and (iii) the DTL can be netted against only a single asset.[56] PNC strongly supports the Agencies recognition in § 22(e) that the amount of an asset subject to deduction can be determined net of any associated DTLs, as we believe this approach more accurately reflects a bank's effective maximum net potential loss on the asset.

We request, however, that the final rules clarify in two respects how the DTL netting permitted by § 22(e) may be applied. First, we respectfully request that the Agencies add additional language to the final rules to make clear that the amount of any significant investment in the capital of an unconsolidated financial institution that is not in the form of common stock, and of any non-significant investment in the capital of an unconsolidated financial institution (whether in the form of common stock or a non-common instrument), that is subject to the corresponding deduction approach under § 22(c)(4) and (5), respectively, may be determined net of associated DTLs (assuming the conditions in § 22(c) are satisfied). This treatment is consistent with the direction in § 22(e) that the netting of DTLs is permitted against any asset subject to a deduction under § 22. Specifically, we recommend that—

[56] See Proposed Rules at § 22(e)(1) and (2). Special rules apply with respect to the netting of DTLs against deferred tax assets ("DTAs") that arise from operating loss and tax credit carryforwards (net of any related valuation adjustments) or that arise from temporary differences that the bank could not realize through net operating loss carrybacks (net of any related valuation adjustments). See id. at § 22(e)(3).

(i) the first part of § 22(c)(4)(i) be revised to read as follows—"A [BANK] must deduct its non-significant investments in the capital of unconsolidated financial institutions that, in the aggregate and net of associated DTLs (in accordance with paragraph (e) of this section), exceed 10 percent . . ."; and

(ii) § 22(c)(5) be revised to read as follows—"The [BANK] must deduct its significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock, net of associated DTLs in accordance with paragraph (e) of this section, by applying the corresponding deduction approach." [footnote omitted]

Similar language is already included in other parts of § 22 (see, e.g., § 22(d)(1)(i), (ii) and (iii)), and including the proposed language in § 22(c)(4)(i) and (c)(5) would ensure the consistent application of the netting authorized by § 22(e).

Second, we believe that the Agencies should clarify in the final rule that a bank may alter the specific assets against which a DTL is netted over time provided that the conditions in § 22(e) continue to be met. For example, a bank that has elected (in accordance with § 22(e)) to net DTLs against MSAs in one reporting period may elect to net such DTLs against another asset subject to deduction under § 22, such as DTAs arising from operating loss and tax credit carryforwards, in a subsequent reporting period so long as the applicable conditions in § 22(e) are satisfied.

F. Capital Conservation Buffer

Section 11(a) of the Proposed Rules implement the capital conservation buffer elements of Basel III. Under these provisions, a bank must maintain each element of its regulatory capital (CET1, Tier 1 and Total Capital) at a level at least 250 basis points higher than the applicable minimum requirement in order to avoid being subject to restrictions on capital distributions and discretionary bonus payments to executive officers.[57] These restrictions limit the aggregate amount of capital distributions and covered discretionary bonus payments in a quarter to a set percentage of the bank's "eligible retained income" during the previous four quarters, with the

[57] Under the Proposed Rules, an advanced approaches bank would determine its compliance with the capital conservation buffer thresholds using only its advanced approaches risk-weighted assets. See Proposed Rules at § 11, n. 2. We believe that this methodology is appropriate and ensures that the buffer is applied in a comparable manner to both U.S. and foreign advanced approaches banks. In addition, applying the capital conservation buffer in this way is fully consistent with Section 171 of the Dodd-Frank Act (the so-called "Collins Amendment"), which requires that the generally applicable risk-based capital rules serve as a floor only to the Agencies' minimum risk-based capital requirements set forth in § 10 of the Proposed Rules. See 12 U.S.C. § 5371(b)(2).

applicable limit (referred to as the "maximum payout ratio") becoming stricter as the bank's capital conservation buffer declines.

As indicated above, PNC supports the overall objectives of the Basel III Framework to strengthen the resiliency of the banking industry through stronger regulatory capital requirements and we recognize that a properly implemented capital conservation buffer will help achieve these objectives. In that spirit, we believe the following changes to the capital conservation buffer would improve the operation of the capital conservation buffer in practice.

1. The Definition of "Eligible Retained Income" Should Be Revised to Eliminate the Double Counting of Items Already Deducted from Regulatory Capital (Basel III NPR, Q. 8)

The Proposed Rules define "eligible retained income" as the banking organization's net income for the four calendar quarters preceding the current quarter, based on the organization's most recent regulatory report (i.e., FR Y-9C or Call Report), net of any capital distributions and associated tax effects not already reflected in net income. Because "net income" for these purposes is adjusted for goodwill impairment losses and amortization expenses for other intangible losses,[58] these expenses and losses will reduce a bank's eligible retained income for purposes of the capital conservation buffer. However, goodwill and other intangible assets are already deducted from CET1 under §§ 22(a)(1) and (2) of the Proposed Rules and, thus, such assets would already have been factored into the bank's capital conservation buffer through a reduction in the bank's capital levels. Including these goodwill impairments and intangible losses in "eligible retained income" would therefore effectively double count these items, a result that we believe is both punitive and unnecessary to achieve the purposes of the capital conservation buffer. Accordingly, we respectfully request that the Agencies modify the definition of "eligible retained income" to exclude charge-offs, impairments and amortization expenses with respect to items that are already otherwise required to be deducted from regulatory capital.

2. Definition of "Capital Distribution" Should be Modified to Avoid Penalizing Banks Engaging in Exchange Transactions That Maintain or Improve Capital

As noted above, under the Proposed Rules all capital distributions (as well as associated tax effects not already reflected in net income) are deducted from net income in calculating eligible retained income.[59] Because this definition of a "capital distribution" includes gross

[58] See Schedule HI of Form FR Y-9C, Items 7(c)(1) and (2), 8, 10, 12 and 13.

[59] Capital distributions are defined to include a (i) repurchase of a Tier 1 capital instrument; (ii) a repurchase or redemption prior to maturity of a Tier 2 capital instrument; (iii) a dividend declaration on any Tier 1 capital instrument; and (iv) a dividend declaration or interest payment

repurchases or redemptions (prior to maturity) of Tier 1 or Tier 2 capital elements, it does not give credit to a bank that replaces redeemed or repurchased capital with an equal or greater amount of capital of an equivalent or higher quality. For example, the proposed definition would discourage banks from replacing high cost capital elements—or even capital instruments, such as trust preferred securities, that no longer fully qualify as capital—with lower cost capital or fully eligible capital elements of an equivalent or higher quality. We believe such a result would be both inapposite and contrary to the purposes of Basel III. Indeed, the Basel Committee indicated that payments that do not result in a depletion of capital should not be considered distributions.[60] Accordingly, we request that the Agencies modify the definition of a "capital distribution" for purposes of the capital conservation buffer to exclude any repurchase or redemption to the extent the capital repurchased or redeemed was replaced by the bank within a calendar quarter by the issuance of capital of an equal or higher quality.

3. Agencies Should Establish an Expedited Review Process For Exception Requests that Are Consistent with Safety and Soundness

As the Proposed Rules recognize, rigid application of the capital conservation buffer could cause results that are not consistent with either the purposes of the capital conservation buffer or safety and soundness considerations.[61] For example, applying the capital conservation buffer limitations to an otherwise healthy banking organization that experiences a temporary drop in the organization's capital and net income solely as a result of a one-time, non-recurring, non-cash charge would appear to be inappropriate and potentially counterproductive. For this reason, we support § 11(a)(4)(iv) of the Proposed Rules, which allows the Agencies, upon request, to grant exceptions to the capital conservation buffer's restrictions based on the facts and circumstances of the requesting banking organization. This authority should assist the Agencies in ensuring that the capital conservation buffer is, as the Basel Committee intended, "sufficiently flexible to allow for a range of supervisory and bank responses."[62]

However, in order for this authority to achieve its purpose, we encourage the Agencies to establish an expedited review process for requests made under § 11(a)(4)(iv). Many organizations, including PNC, authorize and declare dividends shortly after the end of each

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on a Tier 2 capital instrument if such dividend or interest payment may be temporarily or permanently suspended at the bank's discretion. See Proposed Rules at § 2.

[60] See Basel III Framework at ¶ 132(a).

[61] See Proposed Rules at § 11(a)(4)(iv) (permitting a bank, with prior Agency approval, to make capital distributions or covered discretionary bonus payments that otherwise would be limited by the capital conservation buffer if the Agency determines that the payments "would not be contrary to the purposes of [the capital conservation buffer], or the safety and soundness of the [BANK]."

[62] See Basel III Framework at ¶ 28.

quarter and the amount of a one-time, non-recurring charge may not be finally determined until just before quarter-end. Moreover, in some circumstances a bank may be required under applicable accounting rules to record a one-time charge for a quarter as a result of an event that occurred after the quarter-end but prior to the bank's SEC filing for that quarter. Thus, there may be only a short window between when an exception request that is consistent with buffer's purposes and the bank's safety and soundness becomes necessary, and when approval of the exception may be needed to avoid unnecessary harm to the organization's shareholders and reputation.

G. Countercyclical Capital Buffer

The Proposed Rules would implement the countercyclical capital buffer included within the Basel III Framework, with the buffer amount in the United States initially set at zero.[63] The Agencies have indicated that they would take a "range of macroeconomic, financial, and supervisory information" into account in determining whether a countercyclical capital charge should be implemented or raised in order to address "excessive credit growth" that might result in an increase in systemic risk.[64] Although the countercyclical buffer would be implemented as an extension of the capital conservation buffer, the countercyclical buffer—unlike the capital conservation buffer—would apply as proposed only to advanced approaches banks. As discussed further below, we believe that the Agencies should consider activating the countercyclical buffer only after carefully considering and weighing other alternatives that, in our view, likely would be more effective in addressing any perceived excessive credit growth in the United States. Moreover, if any countercyclical buffer is activated in the United States, we believe the buffer should apply to a wider range of banking organizations than proposed.

1. Countercyclical Buffer Decisions Should Take into Account Whether Other Actions Would More Effectively Mitigate any Perceived Excess Credit Growth (Basel III NPR, Q. 10)

We support the Agencies' recognition that any decision to activate or increase the countercyclical capital buffer in the United States should take into consideration a wide range of macroeconomic, financial and supervisory information. However, we are concerned that neither the text of the Proposed Rules, nor the items listed in the Basel III NPR as potential factors for consideration,[65] indicate that the Agencies will consider whether other regulatory, supervisory or

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[63] See Proposed Rules at § 11(b).

[64] See Basel III NPR at 52805.

[65] The factors listed include "the ratio of credit to gross domestic product, a variety of asset prices, other factors indicative of relative credit and liquidity expansion or contraction, funding spreads, credit condition surveys, indices based on credit default swap spreads, options implied volatility, and measures of systemic risk." Id.

governmental actions would likely be more effective in mitigating any potential excessive credit growth. We believe it is critically important that the Agencies take such considerations into account before deciding to activate or increase the countercyclical capital buffer, particularly given the significant limitations inherent in the countercyclical buffer.

For example, to the extent there is excessive credit growth, it may be focused in one, or a small number of, credit markets (e.g., CRE or residential mortgages). In such circumstances, a more effective policy response to mitigate the excessive credit growth likely would be to apply heightened supervisory scrutiny to the particular type of credit (such as to address the potential weakening of underwriting standards) or to adopt a temporary increase in the risk-weight for such exposures under the generally applicable capital rules. These responses would be both more targeted towards the type of credit experiencing excessive growth and more effective as they would apply to all banking organizations, and not just advanced approaches banks, which may not even be the primary source of the "excessive" credit growth in the relevant market.

Even if advanced approaches banks were the primary source of the excessive credit growth, applying a "top-of-the-house" capital charge—rather than targeted supervisory guidance or increased risk-weights—could well be counterproductive. In this regard, because any countercyclical buffer would apply to a banking organization as a whole (and not specific asset classes), imposition of the buffer could actually provide incentives for covered banking organizations to devote additional resources to those credit markets that are experiencing the greatest growth. This is because markets experiencing high growth typically provide higher-than-average returns and, thus, such markets may well provide covered banking organizations the best opportunity to offset the costs of the additional capital buffer.

If, on the other hand, excess credit growth is distributed across a range of credit markets or is driven by a wide range of institutions (including potentially nonbanks and the shadow banking system), monetary policy may well be a more effective policy tool for curbing the excess credit growth than imposition of a countercyclical capital buffer on only advanced approaches banks. The effects of monetary policy decisions are rapidly transmitted across credit markets broadly and affect the decisions of all participants in the financial markets, not just advanced approaches banks or even banking organizations generally.

As the foregoing illustrates, even when one or more credit markets are experiencing excessive growth, activation of the countercyclical capital buffer may not be the best or most appropriate policy response. Accordingly, we respectfully request that the Agencies indicate in the final rules that, in addition to taking into account the factors specified in § 11(b)(2)(iv) of the Proposed Rules, the Agencies will consider, before increasing the countercyclical capital buffer amount, whether other actions by the Agencies (including the Federal Open Market Committee) likely would be more effective to mitigate the excessive ease in the credit markets found to be resulting in a material increase in system-wide risk.

1. Consistent with the Dodd-Frank Act Any Countercyclical Buffer Should Apply to Banking Organizations with $50 billion or More in Assets

PNC agrees that the countercyclical capital buffer should not apply to small, community banks. Such banks often do not have access to the capital markets and, thus, applying cyclical capital requirements to these banks may present special difficulties for the organizations. However, we believe that, if any countercyclical capital buffer is established, the buffer should apply to all banks that have $50 billion or more in total assets. The Dodd-Frank Act provides that bank holding companies that have $50 billion or more in total assets are to be subject to enhanced prudential standards and requirements that are more stringent than those that apply to other banking organizations.[66] Moreover, the Dodd-Frank Act provides that such enhanced prudential standards must include enhanced risk-based capital requirements.

The countercyclical capital buffer is, by definition, design and effect, an enhanced risk-based capital requirement.[67] Thus, consistent with Congress' direction that enhanced risk-based capital standards should apply to bank holding companies with $50 billion or more in total assets, we believe the capital conservation buffer, if activated, should apply to banks with $50 billion or more in total assets.[68] We note that such banking organizations typically have ready access to the capital markets and, thus, the marginal costs of complying with the countercyclical capital buffer likely would not be materially different for banking organizations with $50 billion or more in total assets than for advanced approaches banks.

H. Supplemental Leverage Ratio and the Proliferation of Regulatory Capital Ratios

The Proposed Rules would require advanced approaches banks, beginning January 1, 2018, to comply with both the new supplemental leverage ratio established by Basel III (which takes into account certain off-balance sheet exposures) and the existing U.S. leverage ratio. While we recognize that the Collins Amendment may dictate this result, requiring that advanced approaches be subject to two leverage ratios only compounds the complexity, and likely investor confusion, that will result from the proliferation of regulatory capital ratios that U.S. banks will be subject to under the Proposed Rules.

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[66] See 12 U.S.C. § 5365.

[67] See id. at § 5365(b)(1)(A)(i). The Federal Reserve, in consultation with the FSOC, may determine not to apply heightened risk-based capital requirements to a particular company if the Federal Reserve determines that such requirements are not appropriate for the company and applies other similarly stringent risk standards.

[68] In fact, we believe that applying the countercyclical capital buffer to banks with $50 billion or more in assets would fully satisfy the Federal Reserve's obligation under Section 165 of the Dodd-Frank Act to establish enhanced risk-based capital requirements for such organizations.

Under the existing capital rules, U.S. banks, whether subject to the advanced approaches or not, generally must calculate and report only two risk-based (tier 1 and total) and one leverage capital measure. For organizations with a single bank subsidiary, this means the organization must calculate and report six capital measures, three at the consolidated level and three at the bank level.[69] However, under the Proposed Rules, advanced approaches banking organizations with a single bank subsidiary will be subject to 16 capital measures: six risk-based capital measures (including the new CET1 measure) calculated using risk-weighted assets determined under the generally applicable risk-based rules; six risk-based capital measures calculated using risk-weighted assets determined under the Advanced Approaches; two leverage measures under the existing leverage ratio; and two leverage measures under the new supplemental leverage ratio. Effectively, though, the number of ratios that must be calculated is much higher, as investors seek capital ratio information on a fully-phased Basel III basis.

In light of this multiplicity of capital ratios, we encourage the Agencies to streamline and simplify the application of regulatory capital ratios wherever possible. One relatively easy, yet important, way of doing so would be to better align the timing of the supplementary leverage ratio with the existing leverage ratio. In particular, under the Proposed Rules, while the supplemental leverage ratio would be reported only quarterly, banking organizations subject to the supplementary leverage ratio would have to calculate the ratio each month, with the quarterly reported amount being the simple average of the monthly measures. This monthly calculation requirement adds administrative burden and complexity to the calculation that, in our view, is unlikely to produce a commensurate improvement in the risk-sensitivity of the ratio. Accordingly, we respectfully request that banks be permitted to calculate the supplemental leverage ratio on just a quarterly basis consistent with the manner that the existing leverage ratio is calculated.

III. SIGNIFICANT ISSUES THAT CUT ACROSS THE NPRs

A. Securitization-Related Issues

1. Maximum 1250% Risk Weight Should Be Modified To Avoid Penalizing Banks that Hold Necessary and Prudent Levels of Capital (Advanced Approaches NPR, Q. 15)

Under both the Standardized Approach and the Advanced Approaches, a bank would have to assign a 1250% risk weight to certain types of securitization exposures, including those securitization exposures that do not qualify for the securitization risk-weighting frameworks available under the relevant rule (i.e., the SFA and SSFA under the Advanced Approaches, and the SFA or gross-up approach under the Standardized Approach). However, as the Agencies

[69] For banks subject to the Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR") process, an additional tier 1 common measure also applies at the bank holding company level.

have recognized, applying a 1250% risk weight would require banks that have total capital ratios greater than 8% to hold more than a dollar of capital against each dollar of the relevant securitization exposure and, thus, be more punitive than a dollar-for-dollar capital deduction. [70] Indeed, "[t]he more a [bank's] risk-based capital ratio exceeds 8.0 percent, the harsher is the effect of a 1,250 percent risk weight on [the bank's] risk-based capital ratios."[71]

The proposed 1250% risk weight appears to be a legacy from the minimum total capital requirement (8 percent) under the original Basel Accord, as 1250% is the reciprocal of 8%. However, the effective minimum total capital requirement for all banks under Basel III will be 10.5% (8% minimum plus 2.5% capital conservation buffer). Accordingly, we recommend that the Agencies substitute a 952% risk weight—the reciprocal of 10.5%—for the 1250% risk weight each place it appears in the Proposed Rules. Such a modification could be easily implemented and applied uniformly to all banks and would be consistent with the Agencies' desire to limit differences in the measures of capital between the risk-based and leverage capital requirements.[72] In addition, the modification would at least avoid penalizing banks for maintaining the level of total capital required by the capital conservation buffer.

1. Due Diligence Requirements for Securitizations Should be Applied Flexibly and Consequences of Non-Compliance Should be Tailored Based on Severity and Duration (Advanced Approaches NPR, Q. 13; Standardized Approach NPR, Q. 17)

Under the Proposed Rules, a banking organization must be able to demonstrate to the satisfaction of its primary federal supervisor that the organization has a comprehensive understanding of any feature of a securitization exposure that would materially affect performance. To demonstrate such a comprehensive understanding, the Proposed Rules would require that a bank analyze the following four factors: (1) the structural features of the securitization that would materially impact the performance of the exposure; (2) relevant information regarding the performance of the underlying credit exposure(s); (3) relevant market data for the securitization; and (4) for re-securitization exposures, performance information on the underlying securitization exposures.[73] If the organization's supervisor determines that any of these due diligence requirements have not been met, then the bank must assign a 1250% risk weight to the securitization exposure.

[70] See Advanced Approaches NPR at 52993.

[71] Id.

[72] See id. If desired, the 952% risk weight could be phased in as the capital conservation buffer is phased in, with the risk weight being reduced from 1250% to 1160% on January 1, 2016, 1081% on January 1, 2017, 1013% on January 1, 2019, and 952% on January 1, 2019.

[73] See Proposed Rules at § 141(c) (Advanced Approaches) and § 41(c) (Standardized Approach).

We agree that banking organizations should conduct appropriate due diligence concerning the securitization exposures that they propose to purchase and that such due diligence should include consideration of both the structural features of the securitization and the quality and performance of the underlying assets. Moreover, we support the Agencies' recognition that the required depth of a bank's analysis should depend on "the complexity of the exposure and the materiality of the exposure in relation to [to the bank's] capital." However, we believe the due diligence requirements for securitizations should be clarified or modified in two respects.

First, in light of the significant diversity of securitized products and markets, we believe it is important for the Agencies to recognize that banks will need flexibility in applying the criteria to specific securitization transactions. For example, market data (such as bid-ask spreads and recent sales prices) will not be available for securitizations at issuance and may not be available for securitizations that trade less frequently.

Second, we believe it is inappropriate for a 1250% risk weight (which, as indicated above, we believe should be modified) to be applied immediately and automatically for any non-compliance, regardless of how immaterial, with the proposed due diligence requirements. For example, assume a senior securitization position in a pool of high quality assets has a risk weight under the SSFA of 20%. Under the Proposed Rules, <u>any</u> shortfall in the bank's due diligence process, such as a delay of a few days in documenting the bank's due diligence analysis, could result in more than a <u>60 fold</u> increase in the exposure's risk weighting.

In lieu of such an automatic and potentially punitive penalty, we believe the Agencies should adopt a more tailored approach similar to that already applicable in Europe under Article 122a of the European Union's Capital Requirements Directive ("CRD II"). Under the CRD II framework, if the relevant supervisor determines that a bank has not complied "in any material respect" with similar due diligence requirements for a securitization exposure, the supervisor is directed to progressively increase the risk weight assigned to the exposure based on the severity and duration of the material exception.[74] Under the formula supplied to help guide national authorities in applying this discretion, the risk weight on a securitization exposure originally risk-weighted at 20% would increase initially to 70% if there was a material due diligence exception, and would increase to 470% if the exception remained unremediated for 8 years.[75] Moreover, in deciding whether to apply any heightened risk weight, national authorities are directed to consider whether the exception resulted from circumstances beyond the control of the banking organization, as well as subsequent steps taken by the banking organization to address any deficiencies.[76] Adopting a similar remedial regime would continue to provide banks incentives

[74] <u>See</u> Committee of European Banking Supervisors, *Guidelines to Article 122a of the Capital Requirements Directive* ¶¶ 5 and 105 (Dec. 31, 2010).

[75] <u>Id</u>. at ¶ 104.

[76] <u>Id</u>. at ¶¶ 110 and 111.

to conduct the required due diligence while allowing the penalty for non-compliance to be scaled appropriately to both the materiality and duration of the non-compliance. In addition, adopting this type of remedial framework would promote international consistency in the application of the capital rules.

2. The Calculation of Off-balance Sheet Securitization Exposures Under the Standardized Approach Should Be Modified to Ensure the Equivalent Treatment of Equivalent Risks

Under the Standardized Approach NPR, the exposure amount of an off-balance sheet securitization exposure is generally the notional amount of the exposure.[77] However, if the off-balance sheet securitization exposure is to an asset-backed commercial paper ("ABCP") program, the Proposed Rules provide that the notional amount of the exposure may be reduced to the maximum potential amount that the bank could be required to fund given the ABCP program's current underlying assets (calculated without regard to the current credit quality of those assets).[78] This maximum borrowing amount is commonly known as the program's "available borrowing base." We believe that capping the amount of an off-balance sheet exposure (such as an ABCP liquidity facility) to an ABCP conduit at the available borrowing base is appropriate because, by contract, the bank's commitment to lend is limited to the amount of eligible assets legally isolated and available to serve as collateral.

However, as a result of changes to Statements of Financial Accounting Standards Nos. 166 and 167 (now ASC 860 and 810-10, respectively) and the Agencies' elimination of the exclusion of consolidated ABCP conduits from risk-weighted assets, the ABCP conduits sponsored by banking organizations typically are now consolidated both for accounting and regulatory capital purposes. In addition, for regulatory capital purposes, the off-balance sheet commitments that used to take the form of a liquidity facility to the bank's ABCP conduit have been functionally replaced by lending commitments by the bank or the bank's consolidated ABCP program to the special purpose vehicles ("SPVs") sponsored by the bank's customers.[79] Importantly, the commitments by a bank or its consolidated ABCP conduit to the customer-sponsored SPVs are subject to the same type of available borrowing base cap as the bank's liquidity facility to the ABCP conduit. Thus, while the form of the commitment that is considered an off-balance sheet exposure of the bank has changed (from a commitment to the

[77] See Proposed Rules at § 42(c)(2).

[78] Id.

[79] This is because the bank's liquidity facility to the ABCP conduit is eliminated in the consolidation process, and the commitments by the consolidated ABCP conduit to the customer-sponsored special purpose vehicle are now treated as off-balance sheet exposures of the bank for regulatory capital purposes.

ABCP conduit to a commitment from the bank or its ABCP conduit to the customer-sponsored SPV), the economic structure of the commitment has not.

In light of these facts, we believe the same treatment that is available for off-balance sheet commitments to an ABCP conduit should be available to commitments by a bank or a consolidated ABCP conduit to a customer-sponsored SPV. That is, a bank should be permitted to reduce the notional amount of the commitment to the customer-sponsored SPV to the available borrowing base of the customer-sponsored SPV.

3. The Definition of a "Resecuritization" Should be Modified To Avoid Unintended Consequences

The Proposed Rules would assign higher risk weights to resecuritization exposures and prevent banking organizations from using resecuritization exposures as eligible "financial collateral" for credit risk mitigation purposes. The Agencies indicate that these changes are designed to reflect the fact that the complexity and lack of transparency of certain types of resecuritizations, such as collateralized debt obligations ("CDOs"), resulted in significant losses to banking organizations during the financial crisis.[80]

PNC agrees that complex and opaque resecuritization structures can present heightened risks to banking organizations, as demonstrated during the financial crisis. However, we are concerned that the definition of a "resecuritization" includes certain structures that are more similar to traditional securitizations and that do not exhibit the opacity and complexity of CDOs and other highly structured resecuritization products. In this regard, the Proposed Rules define a resecuritization as a "securitization exposure in which one or more of the underlying exposures is a securitization exposure."[81]

We believe two adjustments to the proposed definition of a resecuritization are necessary to avoid what we believe are unintended consequences. First, we ask the Agencies to clarify that a resecuritization must involve more than one underlying exposure. Resecuritizing a single securitization exposure—which occurs, for example, in a re-REMIC—is substantively no different than adding credit enhancement to the underlying securitization. It would be anomalous to apply the supervisory calibration parameter of 1.5 to a credit-enhanced senior resecuritization exposure and, as a result, treat that exposure as more risky than the single underlying securitization exposure itself.

Second, we believe a modification is necessary to avoid unnecessary disruption to the market for corporate-loan securitizations ("CLOs"). CLOs traditionally have included a small percentage (typically less than 5% of assets) of other CLO exposures in order to enhance

[80] See Advanced Approaches NPR at 52989-90.

[81] See Proposed Rules § 2 (definition of a "resecuritization")(emphasis added).

diversification and liquidity within the CLO. In light of the small percentage of other CLO exposures included in the underlying asset pool, CLOs are readily distinguishable from CDOs and the other opaque and complex resecuritization products that demonstrated significant transparency, pricing and liquidity problems during the financial crisis. Moreover, including existing CLOs that have just a small percentage of their assets invested in securitization exposures in the definition of a "resecuritization" would disrupt the market for these existing products because existing CLO structures cannot readily be amended to provide for the removal of the underlying CLO exposures. For these reasons, we respectfully request that the definition of a resecuritization also be revised to exclude any corporate-exposure securitization in existence on the effective date of the final rules if no more than 5% of the securitization's underlying exposures are corporate-exposure securitization exposures.

4. Conforming Correction Should be Made to the SSFA Portion of the Advanced Approaches NPR

The SSFA is an element of the hierarchy of approaches to securitization exposures under both the Standardized Approach and the Advanced Approaches. One of the key inputs into the SSFA is K_G, which is the weighted-average total capital requirement of the underlying exposures (with unpaid principal used as the weight for each exposure). As the Advanced Approaches NPR makes clear, the Agencies intended for a bank to calculate the weighted-average total capital requirement of the underlying exposures using the risk-weights included in the Standardized Approach regardless of whether the bank was applying the SSFA under the Advanced Approaches or the SSFA under the Standardized Approach.[82]

However, § 144(b)(1) of the Proposed Rules provides that, when applying the SSFA under the Advanced Approaches (Subpart E), K_G is to be calculated using the capital requirements applicable to the underlying exposures "using this subpart", which is the Advanced Approaches. We believe the reference to "this subpart" was inadvertent, and the rule was meant to, and should, refer to subpart D (which contains the Standardized Approach). Otherwise, the SSFA would largely be unavailable to banks using the Advanced Approaches for any purchased securitization exposure, as such banks would not have the necessary information to calculate a PD, LGD and EAD for each underlying exposure.

[82] See Advanced Approaches NPR at 52991 ("The first input is the weighted-average capital requirement under the requirements described in the Standardized Approach NPR that would be applied to the underlying exposures if they were held by directly by the banking organization.") (emphasis added).

5. Required Application of the Securitization Hierarchy to Investment Funds is Unworkable and Would Result in Punitive Capital Charges

Under the equity portions of both the Advanced Approaches and the Standardized Approach, a bank that has an equity exposure to an investment fund would have to use one of three approaches to determine the risk weight for its equity investment in the fund: the Full-Look-through Approach, the Simple Modified Look-through Approach and the Alternative Modified Look-through Approach.[83] Under the Full Look-through Approach, the risk weight of the bank's investment in the fund is based on the risk weight of the fund's actual underlying assets as determined under the Standardized Approach. Under the Simple Modified Look-through Approach and the Alternative Modified Look-through Approach, the risk weight of the bank's equity investment in the fund is determined based on the risk weights that would be assigned under the Standardized Approach to the type of assets that the fund *could* purchase under its governing investment policies.

These provisions likely would result in punitive capital charges being assigned to any investment in an investment fund (including those held through BOLI/COLI separate accounts) that holds, or is authorized to hold, private securitization exposures (i.e., securitization exposures that are not guaranteed by a government agency or GSE). Specifically, investment funds typically do not provide investors sufficient information to calculate the risk-weight for any private securitization exposure held by the fund under the SSFA or the gross-up method—the two methods available for determining the risk weight of a private securitization exposure under the Standardized Approach. Thus, a bank seeking to use the Full Look-through Approach likely would have to assign a 1250% risk-weight to any private securitization exposure held by the fund, regardless of the actual quality of the exposure.

The difficulties posed by the Proposed Rules are even more pronounced for banks seeking to use the Simple Modified Look-through Approach or the Alternative Modified Look-through Approach. In this regard, banks cannot apply the SSFA or gross-up method to a hypothetical securitization holding. Thus, a bank applying the Alternative Modified Look-through Approach would have to assign a 1250% risk weight to the maximum percentage of private securitization exposures that the fund could acquire—even if the fund was limited to purchasing highly rated private securitization exposures. In addition, a bank applying the Simple Modified Look-through Approach to a fund that may acquire any amount of private securitization exposures would have to assign a 1250% risk weight to its entire equity investment in the fund. We do not believe that these results were intended.

Accordingly, we recommend that the Agencies modify both the Standardized Approach and the Advanced Approaches to allow a bank using any of the three look-through approaches to assign a 100% risk weight to investment grade private securitization exposures, and a 400% risk

[83] See Proposed Rules at § 53 (Standardized Approach) and § 154 (Advanced Approaches).

weight to non-investment grade securitization exposures, that are held or could be held by an "eligible" investment fund. An "eligible" investment fund for these purposes would mean a fund the governing investment policies of which limit the fund's holdings of private securitization exposures to 25 percent or less of the fund's total assets. Importantly, a bank using this modified approach should be permitted to rely on the fund's governing investment policies (such as its prospectus) to determine whether the private securitization exposures that are or may be held by the fund are investment grade for these purposes. Otherwise, banks would effectively be foreclosed from using the Simple Modified Look-through Approach or the Alternative Modified Look-through Approach as banks cannot conduct a more detailed "investment grade" analysis of a hypothetical securitization holding of a fund, just as they cannot apply the SSFA to such a holding.

We believe these modifications strike an appropriate balance between risk-sensitivity and operational necessity. In this regard, the proposed 100% risk weight is the highest risk weight applicable to investment grade securitization exposures, and the 400% risk weight is the highest risk weight applicable to non-investment grade securitization exposures, held by an investment fund under the look-up table in the current Basel II rules.[84] Moreover, the proposed definition of an "eligible" investment fund ensures that a bank could apply these modified risk weights only with respect to funds that limit their investment in private securitization exposures to 25 percent or less of the fund's assets, thereby limiting the potential for regulatory arbitrage.

B. <u>Definition of "Advanced Approaches [BANK]"</u>

Under the Proposed Rules, an "Advanced Approaches [BANK]" is defined as any bank that is required to become subject to the Advanced Approaches because the bank has (i) $250 billion or more of total assets, (ii) $10 billion or more of on-balance sheet foreign exposure, or (iii) elected to use the Advanced Approaches to calculate its risk-weighted assets.[85] Accordingly, this definition would include a bank, such as PNC, that is subject to the Advanced Approaches but that has not yet entered and/or received regulatory approval to exit its mandatory parallel run under the Advanced Approaches (a "pre-exit bank").

We believe the inclusion of pre-exit banks in the definition of an Advanced Approaches bank was unintentional, as treating pre-exit banks as an "Advanced Approaches bank" would have a variety of unintended consequences that are at odds with the Advanced Approaches NPR itself. For example, under the Advanced Approaches NPR, a bank must conduct a satisfactory parallel run in order to determine its risk weighted assets under the Advanced Approaches.[86] However, under the proposed definition of an "Advanced Approaches [BANK]," a *pre-exit bank*

[84] <u>See</u> 12 C.F.R. part 225, App. G, § 54, Table 10.

[85] <u>See</u> Proposed Rules at § 2 (definition of "Advanced Approaches [BANK]") and § 100(b).

[86] <u>See</u> Proposed Rules at § 121.

would have to calculate and use its risk-weighted assets under the Advanced Approaches to determine its regulatory capital ratios under section 10(c) of the Proposed Rules and its compliance with the capital conservation buffer under section 11(c) of the Proposed Rules. In addition, the proposed definition of an "Advanced Approaches [Bank]" would have the odd effect of exempting a pre-exit bank from both the disclosure requirements of the Standardized Approach and the disclosure requirements of the Advanced Approaches.[87] Accordingly, we believe the definition of an "Advanced Approaches [BANK]" in § 2 of the Proposed Rules should be modified to include only a banking organization that is subject to the Advanced Approaches under § 100(b)(1) and that has successfully completed its required parallel run under § 121(c) of the proposed Rules.

II. STANDARDIZED APPROACH NPR PROVISIONS RELATING TO RESIDENTIAL MORTGAGES

The Standardized Approach NPR would revise substantially the risk weights for residential mortgage loans that would apply to all banking organizations, either directly or as a result of the Collins Amendment, under the generally applicable risk-based capital rules. The proposal would require that banks classify residential mortgage exposures as Category 1 or Category 2 exposures based, in part, on characteristics that, in the view of the Agencies, contributed to significant deterioration in the U.S. housing market and unprecedented levels of loan defaults and home foreclosures. The Agencies indicate that these characteristics include "inadequate underwriting standards, the proliferation of high-risk mortgage products, such as so-called pay-option adjustable rate mortgages, . . . [and] the practice of issuing mortgage loans to borrowers with unverified or undocumented income."[88] The risk weight for a residential mortgage exposure would then be based on the exposure's classification (i.e., Category 1 or Category 2) and its loan-to-value ("LTV") ratio as of origination or (with certain exceptions) modification. While the current risk weights for residential mortgages under the generally applicable risk-based rules vary from 50% to 100%, the Proposed Rules would significantly increase both the range and upper bound of applicable risk weights to between 35% and 200%.

PNC Mortgage, a division of PNC Bank, originates first-lien mortgage loans throughout the United States and PNC also originates closed-end home equity loans and home equity lines of credit ("HELOCs"). PNC originated more than $10 billion in residential mortgages in the first three quarters of 2012, and held more than $38 billion of home equity loans in portfolio, as of

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[87] This is because the disclosure requirements under the Standardized Approach apply to a bank "that is not an advanced approaches [BANK]" and the Advanced Approaches disclosure requirements apply only to an advanced approaches bank "that has successfully completed its parallel run". See Proposed § 61 (Standardized Approach) and § 172(c)(1) (Advanced Approaches).

[88] See Standardized Approach NPR at 52898.

June 30, 2012. PNC's mortgage team serves our customers through approximately 2,900 retail banking branches and our network of 143 retail mortgage offices in the continental United States.

PNC supports the Agencies' efforts to ensure that the risk weights for residential mortgage loans appropriately reflect the relative riskiness of different types of mortgage exposures. As a general matter, PNC agrees that residential mortgages with high LTV ratios and/or product features that have been demonstrated to present higher risk warrant higher risk-weights than loans with lower LTV ratios or that lack such higher risk features. However, given the importance of residential mortgages to consumers and the financial system, we believe it is critical that any adjusted risk weights be appropriately calibrated to the actual risk of the relevant exposure so that the capital rules do not, on the one hand, act as an impediment to prudent mortgage lending, homeownership and credit availability or, on the other hand, create unintended incentives for lenders to favor risky loans over safer loans. We offer below recommendations that, in our view, would improve the risk-sensitivity of the proposed framework for residential mortgages. Moreover, we believe tailored transition arrangements are necessary for existing mortgage loans and securitizations backed by residential mortgage loans to permit banks to transition to any new framework.

A. The Agencies Should Establish Tailored Transition Arrangements for Existing Mortgages and Securitizations Backed by Such Mortgages (Standardized Approach NPR, Q. 5)

Under the Proposed Rules, the new risk weights would apply not only to loans made after the effective date of the final rules, but also to existing and performing mortgages. PNC strongly believes that the Agencies should establish tailored transition arrangements for existing, seasoned mortgages that would permit the existing risk weights for such loans to continue. We believe such tailored transition arrangements are necessary to ensure that the Proposed Rules do not impose undue burdens on banking organizations, including community banks, and do not result in inappropriate risk weights being assigned to existing mortgages solely due to data and resource constraints. Moreover, we believe the type of tailored transition arrangements proposed below—which are limited to seasoned and performing loans that lack the potential for significant future payment shock—help ensure that the proposed new risk weights would apply to those existing loans that may present higher risk.

Because the criteria for a Category 1 mortgage were only just proposed, these criteria were not known to PNC or other banking organizations when existing mortgages were originated. Accordingly, applying these new criteria to existing mortgage would require that banks of all sizes conduct a review of their entire current portfolio of outstanding mortgages to determine whether the loan meets all of the criteria to be a Category 1 mortgage. This alone would impose a substantial burden on banking organizations of all sizes.

However, because the criteria for classifying loans as "Category 1" or "Category 2" loans were not in existence or known at the time of origination, the information necessary to establish that many existing mortgage loans are, in fact, a Category 1 mortgage likely will not be in a bank's relevant source systems and may well not even be available in the underlying loan files. For example, a Category 1 mortgage requires, among other things, that the originator applied underwriting standards that "[t]ook into account all of [a] borrower's obligations, including for mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance), and assessments."[89] Although the originator may have taken these considerations into account in underwriting the loan, this fact may well have not been documented or entered into the originator's source systems because they were not required to be. Accordingly, even mortgage loans that actually were originated in accordance with the newly proposed criteria for Category 1 loans may have to be classified as Category 2 loans, and subject to the substantially higher risk weights applicable to Category 2 loans, simply due to data limitations resulting from the fact that the Category 1 criteria were not known or captured at the time of origination.

In light of these facts and concerns, PNC believes that a bank should be permitted to continue to apply the risk weights under the current generally applicable risk-based capital rules to any residential mortgage loan that—

- Was originated on or before the earlier of (i) the date that is one year after the date the final Standardized Approach rules are published in the Federal Register, or (ii) the date that is six months before the final Standardized Approach rules become effective;
- Prior to that date was never 60 days or more past due;
- After such date, does not become 90 days or more past due or on non-accrual status; and
- Does not have terms that allow for the deferral of principal or will result in a balloon payment.

We believe these tailored transition arrangements for seasoned and currently performing loans sensibly balances the need to provide banking organizations an appropriate period of time to transition to the new risk-weighting criteria once finalized with the goal of ensuring an appropriate capital charge for potentially higher risk loans. In this regard, as noted above, these transition arrangements would be available only to "seasoned" mortgage loans that have a track record of adequate performance and that lack features that could result in significant "payment shock" for borrowers in the future. Moreover, a mortgage loan would no longer qualify for the transition arrangements if it were to become 90 days or more past due, or be placed on non-accrual status.

[89] Proposed Rules at § 2 (definition of a "Category 1 residential mortgage exposure", paragraph (3)(i)).

A similar transition period also is necessary for securitizations that are backed by residential mortgages, as bank investors in securitizations will have even less of an ability to determine whether the residential mortgages backing an outstanding securitization meet the criteria to be a Category 1 loan once those criteria are finalized. Accordingly, we believe that, a transition period should be available for securitization transactions that are issued on or before the earlier of (i) the date that is one year after the date the final Standardized Approach rules are published in the Federal Register, or (ii) the date that is six months before the final Standardized Approach rules become effective. For such securitization transactions, a bank should be permitted to apply the risk weights currently applicable under the general risk-based capital rules to any underlying mortgage exposures that meet the criteria outlined above for purposes of determining K_G (the weighted average capital requirement for the underlying exposures) under the SSFA in both the Standardized Approach and the Advanced Approaches.

B. Qualified Mortgages and HELOCs Should be Considered Category 1 Mortgages (Standardized Approach NPR, Q. 5)

1. Qualified Mortgages Must Meet Criteria That Were Designed to Ensure the Loans Present Lower Risk

In the Standardized Approach NPR, the Agencies specifically request comment on whether all residential mortgage loans that meet the eligibility criteria to be considered a "qualified mortgage" ("QM") under section 129C(b) of the Truth in Lending Act ("TILA") should be included in Category 1.[90] PNC believes that satisfying the QM criteria should be a *non-exclusive* means for a mortgage to be considered a Category 1 loan.

In the Dodd-Frank Act, Congress enacted new section 129C of TILA, which requires creditors for "residential mortgage loans" to make a "reasonable and good faith determination based on verified and documented information that, at the time the loan is consummated, the consumer has a reasonable ability to repay the loan."[91] Section 129C also defines a set of mortgages—QMs—that are deemed to meet this ability-to-repay requirement. Importantly, in order for a residential mortgage loan to be a QM under the statute—

- The loan must—
  - Be fully amortizing;
  - Have a term of not more than 30 years; and

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[90] See Standardized Approach NPR at 52899; 15 USC § 1639c (as added by section 1402 of the Dodd-Frank Act). For purposes of the QM definition, a "residential mortgage loan" does not include HELOCs and other open-end mortgage loans. See 15 U.S.C. § 1602(5).

[91] 15 USC § 1639c(a)(1).

- Not provide for a balloon payment; and
- The originator of the loan must have underwritten the loan—
  - Using the borrower's verified and documented income and financial resources; and
  - Based on the maximum rate permitted under the loan during the first five years and a payment schedule that fully amortizes the loan over the term and takes into account all applicable taxes, insurance and assessments.[92]

We believe these same features distinguish QMs from the types of "high-risk" mortgage products and practices—including pay-option adjustable rate mortgages and the failure to verify and document borrower income—that the Agencies correctly note caused unprecedented levels of mortgage defaults during the financial crisis.[93] Indeed, Congress adopted a QM definition precisely to identify certain loans that present lower risk—to both the borrower and the lender—and to provide regulatory incentives for banks to make such loans. For these same reasons, we believe all mortgage loans that meet the criteria to be a QM should also be considered a Category 1 loan for capital purposes. However, as discussed further below, we believe that other non-QMs should also be considered Category 1 loans and, thus, we believe QM status should be a non-exclusive way for a mortgage loan to qualify as a Category 1 loan.

2. Category 1 Criteria Should be Modified to Accommodate HELOCs

As noted above, PNC believes it is critically important for residential mortgage risk weights to be calibrated appropriately to the risk of the particular mortgage. Otherwise, the capital rules could unintentionally discourage and raise the cost of less risky mortgage products while, at the same time, creating regulatory incentives for lenders to make higher risk mortgages. We believe that HELOCs—home equity lines of credit—are one product where adjustments to the proposed risk-weighting framework are clearly warranted.[94]

A recent Federal Reserve staff report concluded that *second-lien* HELOCs had a very different risk profile than closed-end second liens and, in fact, had default rates that were similar to prime, *first-lien* conforming residential mortgages.[95] As this Fed Staff Report indicates:

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[92] Id. at § 1639c(b)(2). Certain exceptions to the prohibition on balloon payments are available to lenders that primarily operate in rural or underserved areas.

[93] See Standardized Approach NPR at 52898.

[94] As noted above, because HELOCs are an open-end credit product, they cannot meet the definition of a QM.

[95] See Donghoon Lee, Christopher Mayer, and Joseph Tracy, *A New Look at Second Liens*, Federal Reserve Bank of New York Staff Reports, Staff Report No. 569 (Aug. 2012) ("Fed Staff Report").

> "Even though HELOCs and [closed-end second liens] are both classified as second liens, they are quite different. . . . [Closed-end second liens] have similar characteristics to non-prime first mortgages. . . . By contrast, HELOCs are more closely related to conforming/prime first mortgages."

In light of this data, which includes loan performance through the financial crisis and 2011, it does not appear justifiable to treat second-lien HELOCs as higher risk Category 2 loans just like "piggy-back" closed-end second lien mortgages or pay-option ARMs. Moreover, it would be highly anomalous if *first-lien* HELOCs were required to be classified as Category 2 mortgages when the Fed Staff Report demonstrates that the delinquency rate for second-lien HELOCs is similar to prime, GSE-guaranteed conforming first-lien mortgage.

Accordingly, we respectfully request that the Agencies modify the Proposed Rules to permit banks to classify a junior-lien HELOC as a Category 1 loan if the loan meets all of the other Category 1 criteria, as modified below. In addition, we request that the Agencies modify the criteria for Category 1 loans in the following two ways to accommodate the unique features of HELOCs. Absent these modifications even first-lien HELOCs could be inappropriately classified as "higher risk" Category 2 loans.

First, HELOCs typically have an interest rate that varies during the draw period based on an index, without any pre-set cap. However, under the Proposed Rules, a mortgage loan can be classified as a Category 1 loan only if the terms of the loan limit any interest rate increases to no more than 2 percent in any one year or 6 percent over the life of the loan.[96] Absent modification, this term could effectively prevent low-risk HELOCs from qualifying as Category 1 loans. Accordingly, we recommend that the Agencies permit a HELOC to qualify as a Category 1 loan (even if the terms of the loan during the draw period may permit interest rate increases beyond the 2 percent/6 percent specified in the Proposed Rules) <u>provided that</u> the borrower has the right to convert the loan to a fixed rate any time during the draw period. We believe this type of borrower option effectively addresses the concerns underlying the 2 percent/6 percent limits.

Second, the Proposed Rules limit Category 1 loans to those with a term that does not exceed 30 years.[97] While a 30-year maximum term may be appropriate for closed-end loans, HELOCs are typically structured with both an open-end draw period and a subsequent closed-end term during which the balance at the conclusion of the draw period is fully repaid. It is not uncommon for HELOCs to have draw periods of up to ten years and subsequent closed-end payout periods of between 20 and 30 years. A closed-end payout period of 20-30 years provides

[96] See Proposed Rules at § 2 (paragraph (4) of the definition of a "Category 1 residential mortgage exposure").

[97] Id.

the borrower a longer period to pay back the principal owed at the end of the draw period, and is equivalent to a 20-30 year closed-end mortgage for the same amount. Accordingly, we respectfully request that the Agencies permit a HELOC to qualify as a Category 1 loan provided that (i) the draw period on the HELOC is no more than 10 years and the closed-end payout period is no more than 30 years; and (ii) the loan is fully amortizing throughout its term.

C. **Only "Piggy-Back" Junior Liens Should Be Combined with a Separate First-Lien for Capital Purposes** (Standardized Approach NPR, Q. 5)

Under the Standardized Approach NPR, if a bank holds both a first-lien mortgage and a junior-lien mortgage on the same property, the bank would be required to (i) treat the first-lien mortgage as a Category 2 mortgage even if it otherwise qualified as a Category 1 mortgage; and (ii) use the combined LTV of both the first-lien and the second-lien mortgage in determining the risk weight applicable to both the first-lien and the second-lien mortgage.[98] We believe these provisions fail to appropriately distinguish between "piggy-back" junior-liens that are originated simultaneously with the first-lien mortgage, and second-lien mortgages (such as HELOCs) that are obtained independently and subsequent to the first-lien mortgage.

As the recent Fed Staff Report highlights, there are important differences between piggy-back junior liens and junior liens originated after the first-lien mortgage.[99] For example, this study indicates that piggy-back second liens "contributed to home purchases at times and in locations where home values likely exceeded fundamental values, potentially helping to fuel the housing bubble.[100] Moreover, as the report indicates, piggy-back junior liens often were used by borrowers to make very small down payments. "Mortgages with a piggyback second lien had very high origination CLTVs, with almost two-thirds of borrowers having a down payment of 5 percent or less."[101] Because piggy-back junior liens frequently are used essentially as a substitute for a down payment or private mortgage insurance on the first-lien, there is some logic to treating the two products as one and using the CLTV (including the amount of the piggy-back second lien) in determining the appropriate risk-weight for the first-lien mortgage originated at the same time.

However, we do not see the logic or the data that would support "tainting" a first-lien Category 1 mortgage originated by a bank solely due to the later and separate origination of a junior lien mortgage on the property by the same lender. A "subsequent" second, by definition, could not have been used by the borrower to effectively lower the borrower's required down

98 Standardized Approach NPR at 125 (emphasis added).

99 See Fed Staff Report.

100 Id. at 7.

101 Id. at 14.

payment for the first-lien mortgage. Moreover, as the Fed Staff Study indicates, second liens taken out subsequent to a purchase transaction perform much better than piggy-back second liens, with the rate of delinquency across origination years declining the longer the period of time between the origination of the first lien and the second lien.[102] In addition, the report notes that "second liens taken out subsequent to the first lien are more likely than piggyback seconds to remain current following a delinquency on the first lien", which demonstrates that there is a weaker "linkage" between a first lien and subsequent second lien than between a first lien and a piggyback second. Accordingly, we believe the Proposed Rules should be modified to treat first and junior mortgages separately, unless the junior lien is originated and funded simultaneously with the first-lien mortgage in a piggy-back loan.

We believe these changes are particularly important for two reasons. First, absent the changes described above, first-lien mortgage lenders could face substantial increases in the risk weighting of a performing and low risk Category 1 mortgage solely as a result of the subsequent origination of a small junior lien to the borrower. The following example, which is included in the ABA/SIMA/FSR Comment Letter, illustrates this point: Assume a bank has an existing $50,000 Category 1 first-lien mortgage on a property (with a $100,000 value) and subsequently originates a $5,000 Category 2 junior-lien mortgage. The risk-weighted asset ("RWA") amount for the initial $50,000 Category 1 first lien loan is $17,500. Under the Proposed Rules, however, the addition of the $5,000 Category 2 second lien loan would dramatically increase the RWA amount for the Category 1 first-lien to $50,000, with the combined RWA amount for both the loans being $55,000. The increase in the combined RWA amount (from $17,500 to $55,000) is the marginal increase in RWA caused by extending the $5,000 second lien. Thus, the effective marginal risk weight for this $5,000 junior lien is *750 percent.*

Second, we are concerned that, absent our proposed modifications, the Proposed Rules will significantly disrupt customer relationships and have other unintended consequences. It is very common for a borrower to obtain a HELOC from the same lender that provided a first mortgage on the property. From both a risk and customer-relationship standpoint this is preferable, as the first mortgage lender can draw on its experience with the borrower in offering the additional mortgage loan. The Proposed Rules, however, would effectively force mortgage customers of a bank to go to a different bank—or a nonbank lender—to obtain any subsequent HELOC or other junior-lien product. This will not only disrupt ongoing customer relationships, it will complicate loss mitigation (including loan modification) efforts should the borrower experience difficulty in repaying the mortgage loans. As banks and supervisors have learned, loss mitigation and loan modification efforts are more complicated when unaffiliated entities hold the different liens because both parties must agree to modifications, restructurings or refinancings.

[102] Id. at 16.

D. The Agencies Should Modify the Proposed Rules to Treat All Sustainable Loan Modifications Equally and Facilitate Forbearance Programs that Assist Borrowers

The Standardized Approach NPR generally requires that, if a mortgage loan is modified or restructured, the bank must reclassify the mortgage and update its LTV ratio based on the modified or restructured terms of the mortgage. However, the Proposed Rules would exempt modifications and restructurings conducted under the Home Affordable Modification Program ("HAMP") from this requirement.

As the Agencies have recognized, modifications and restructurings "can be an effective means for a borrower to avoid default and foreclosure and for a banking organization to reduce risk of loss."[103] However, HAMP is not unique in achieving these objectives. Many private, non-government-sponsored modifications can be, and are being, structured to be at least as likely as HAMP to create sustainable, performing loans. Accordingly, we believe that the Agencies should expand the exemption provided for HAMP modifications to include other modification and restructuring programs that meet key sustainability criteria. Expanding the exemption to include sustainable private modifications would promote the public policy objectives of helping banking organizations reduce risk and borrowers remain in their homes, just as is true for HAMP modifications. PNC would welcome the opportunity to work with the Agencies in developing appropriate sustainability criteria for private or other non-HAMP modifications or restructurings to qualify for this treatment.

In addition, PNC urges the Agencies to clarify in the final rule that a forbearance agreement that takes effect before a loan is 90 days or more past due will not change the risk weighting status of the mortgage exposure. A forbearance agreement is an arrangement whereby the servicer of the loan agrees to a suspension or reduction in mortgage payments for a relatively short period of time, perhaps six months to a year. These agreements are typically made to respond to a temporary hardship of a borrower, such as loss of a job or illness. At end of the agreed-upon forbearance period, it is expected that the borrower will resume payments on the original terms of the mortgage.

Under the Standardized Approach NPR exposures that are 90 days or more past due must be treated as Category 2 exposures.[104] We do not believe that the Agencies intended to consider the suspension of payments that last for more than three months (i.e., 90 days or more) to be considered a loan that is 90 days or more past due. However, we urge the Agencies to clarify this in the final rule. In addition, we ask the Agencies to clarify that forbearance agreements do

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[103] Standardized Approach NPR at 52900.

[104] Proposed Rules at § 2 (definition of a "Category 1 residential mortgage exposure", paragraph (7)).

not constitute a "modification" or "restructuring" of the relevant mortgage exposure because the original contractual terms of the mortgage still apply.

E. **Recognize Certain "Qualifying" Private Mortgage Insurance** (Standardized Approach NPR, Q. 6)

Under the Standardized Approach NPR, a bank is not permitted to take into account private mortgage insurance ("PMI") in any way in determining the risk weight for a mortgage exposure. The Agencies, however, specifically request comment on whether banks should be permitted to recognize PMI for purposes of calculating the LTV ratio of a residential mortgage exposure and, if so, what criteria could be used to ensure that "only financially sound PMI providers are recognized."[105]

PMI, whether covering an individual mortgage or a pool of mortgages, does help mitigate the credit risk of the covered mortgage(s). Moreover, PMI has played an important and useful role in the mortgage markets by enabling borrowers, especially first-time homebuyers and lower-income borrowers that want to own their own homes, to quality for mortgage credit with lower down payments. For these reasons, we strongly believe that the Agencies should permit PMI to be taken into consideration as a credit risk mitigant in determining the appropriate risk weight for a mortgage loan under the Standardized Approach.

We recognize, however, that the effectiveness of PMI as a credit risk mitigant depends on the financial strength of the PMI issuer. Accordingly, we support the recommendations included in the ABA/SIFMA/FSR letter that would permit PMI to be recognized as a credit risk mitigant only if the PMI was issued by a provider that (i) met a set of rigorous, prudential standards designed to ensure that the provider could pay claims even during prolonged periods of economic stress (a "Qualified PMI Provider"); or, alternatively, (ii) is determined to be financially sound using an "investment grade" standard similar to that already incorporated into the Proposed Rules.

F. **Adjust the Credit Conversion Factor for Exposures Arising as a Result of Early Payment Default and Premium Refund Clauses to Correspond with Actual Risk** (Standardized Approach NPR, Q. 10)

The Standardized Approach NPR would change the current risk-based capital treatment of mortgage loans that are sold subject to a credit enhancing early payment default or premium refund clause. As a general matter, a credit enhancing early payment default clause requires the seller of a mortgage loan, upon request, to repurchase the loan based solely on the failure of the borrower to make one or more payments on the loan within a specified period (typically 120 days); a credit enhancing premium refund clause requires the seller of a mortgage loan to

[105] Standardized Approach NPR at 52899, Q. 6.

refund, upon request, any premium paid by the purchaser if the loan defaults within a specified period of time. While the current risk-based rules generally do not require a bank to hold capital against mortgage loans sold subject to credit enhancing early payment default or premium refund clauses, the proposed Standardized Approach rules would require that banks treat any mortgage sold to third parties subject to such clauses as being an off-balance sheet guarantee and apply a 100 percent credit conversion factor ("CCF") to the full amount of the loan. Essentially, this approach would require banks to hold capital against any mortgage loans sold to a third party subject to such clauses as if the loans continued to be on the bank's balance sheet for the duration of the early payment default or premium refund clause.

We recognize that credit enhancing early payment default clauses and premium refund clauses can result in some continuing credit exposure to the selling bank.[106] However, we believe that applying a 100 percent CCF to such exposures is excessive and not consistent with the actual risk exposure created by such clauses for the selling bank. We are particularly concerned with the effect that applying such a high and unwarranted CCF could have on banks, including community banks, in light of the recent decision by Fannie Mae and Freddie Mac to require the inclusion of an early payment default clause in the representations and warranties that must be provided by a seller on loans sold to the GSEs on or after January 1, 2013.[107]

Specifically, as noted above, applying a 100% credit conversion factor to mortgage loans sold pursuant to a credit enhancing early payment default clause requires a bank to continue to hold capital as if it continued to hold the loans on its balance. That is, it essentially assumes that all of the mortgage loans covered by the early payment default clause will experience an early payment default and be "put back" to the selling bank. However, experience demonstrates that, even during the height of the financial crisis, only a very small percentage of mortgage loans experience an early payment default. The percentage of mortgage loans that would be sold to the GSEs and that might experience an "early payment default" as defined by the GSEs—that is, the borrower makes no payments during the first 3 months—is likely to be even smaller.[108] Thus, we believe it would be particularly inappropriate for a bank to have to hold capital against the full amount of mortgage loans sold to the GSEs (or another buyer) for the duration of any early payment default clause even though only a very small amount of such loans would ever be "put

[106] We understand that premium refund clauses that are triggered by a prepayment of the loan by the borrower are not considered a "credit enhancing" representation and warranty for purposes of the Proposed Rules and, thus, would not be considered a guarantee and subject to any CCF. We respectfully request that the Agencies confirm this understanding in the final rules.

[107] See Freddie Mac, Bulletin 2012-18, at 6 (Sept. 11, 2012); Fannie Mae, Selling Guide Announcement SEL-2012-08, at 7 (Sept. 11, 2012).

[108] See id.

back" to the selling bank as a result of the clause.[109] Accordingly, we recommend that the Agencies lower the CCF applicable to mortgage loans sold pursuant to an early payment default or premium refund clause to 20% at most.

III. CONCLUSION

Thank you for the opportunity to comment on the Proposed Rules. We would be pleased to discuss our comments with representatives of the Federal Reserve, OCC and FDIC at your convenience. In addition, if you have any questions regarding this letter, please do not hesitate to contact Randall C. King, Executive Vice President, Head of Liability & Capital Management, at (412) 762-2594 or randall.king@pnc.com, or Kieran J. Fallon, Chief Counsel Regulatory Affairs, at (202) 973-6256 or kieran.fallon@pnc.com.

Sincerely,

James E. Rohr

James E. Rohr
Chairman and Chief Executive Officer

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[109] Application of a 100% CCF to a loans sold pursuant to a premium refund clause is even more inappropriate given that the bank's exposure as a result of the clause is limited to the amount of the premium paid by the buyer for the mortgage loan—not the full amount of the mortgage loan.

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