American Bankers Association
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THE FINANCIAL SERVICES ROUNDTABLE
*Financing America's Economy*

October 22, 2012

*By electronic submission*

Re: **Comment Letter on Proposals to Comprehensively Revise the Regulatory Capital Framework for U.S. Banking Organizations**

Ladies and Gentlemen:

The American Bankers Association, the Securities Industry and Financial Markets Association and The Financial Services Roundtable ("**Associations**")[1] appreciate the opportunity to comment on the three notices of proposed rulemaking[2] issued by the Agencies[3] that would comprehensively revise the regulatory capital framework for all U.S. banking organizations.

The proposals, which the Agencies propose to extend to all U.S. banking organizations,[4] would represent the most comprehensive overhaul of the U.S. bank capital framework in over two decades and would start to take effect at a time when the United States is only beginning to recover from a deep economic recession. It is of paramount importance

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[1] Further information about the Associations is available in Annex D.

[2] The three proposals are (i) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action ("**Basel III Numerator NPR**"), 77 Fed. Reg. 52,792 (Aug. 30, 2012); (ii) Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements ("**Standardized Approach NPR**"), 77 Fed. Reg. 52,888 (Aug. 30, 2012); and (iii) Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule ("**Advanced Approaches NPR**"), 77 Fed. Reg. 52,978 (Aug. 30, 2012). Collectively, these are referred to in this letter as the "**proposals**."

[3] The "**Agencies**" refers to the Office of the Comptroller of the Currency ("**OCC**"), the Board of Governors of the Federal Reserve System ("**Federal Reserve Board**"), and the Federal Deposit Insurance Corporation ("**FDIC**").

[4] The Agencies propose to apply the revised capital framework to all national banks, state member banks, state nonmember banks, state and federal savings associations and top-tier bank holding companies domiciled in the United States not subject to the Federal Reserve Board's Small Bank Holding Company Policy Statement, 12 C.F.R. Part 225 Appendix C, as well as top-tier savings and loan holding companies domiciled in the United States, regardless of size.

that such fundamental revisions to the U.S. bank capital framework accommodate the twin goals of better aligning regulatory capital requirements with actual risks and fostering a financial regulatory environment that is conducive to the level of credit availability that can support a strong economic recovery and long-term economic growth. As discussed in detail in this letter, many aspects of the proposals do not meet these goals and, if adopted, would likely hinder credit availability, dampen economic growth and harm the competitiveness of the U.S. banking system and the U.S. financial sector.

The Associations have consistently voiced strong support for ongoing regulatory reform efforts that aim to make financial systems safer and more robust. This includes support for improving the quality of capital in banks and increasing the risk sensitivity of bank capital requirements in such a way that will enhance the ability of the banking sector to serve customers and promote economic growth. As the Agencies themselves have all acknowledged, the U.S. banking sector has shown its commitment to increasing and strengthening its capital base in recent years.[5] Specifically, the average Tier 1 capital ratio of the U.S. banking sector was 12.7 percent in 2011, compared with 7.5 percent in 2007; an increase of 70 percent in just four years under challenging economic conditions.[6]

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[5] **Federal Reserve Board:** "U.S. firms have built up their capital levels . . . since the government stress tests in 2009. The 19 bank holding companies that participated in those tests and in the 2011 and 2012 CCAR have increased their tier 1 common capital levels to $759 billion in the fourth quarter of 2011 from $420 billion in the first quarter of 2009. The tier 1 common ratio for these firms, which compares high-quality capital to risk-weighted assets, has increased to a weighted average of 10.4 percent from 5.4 percent." *See* Press Release, Federal Reserve Board, *Federal Reserve Announces Summary Results of Latest Round of Bank Stress Tests* (Mar. 13, 2012), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20120313a.htm.

**OCC:** "In the aftermath of the recent crisis, levels of capital and allowance for loan losses (ALLL) across the industry are more robust and of higher quality than prior to the recession . . . . Banks have raised significant amounts of equity capital, strengthening their balance sheets . . . . Capital quality has strengthened notably in recent years for the largest banks, as measured by the median percentage of Tier 1 capital relative to total assets. Banks with assets less than $1 billion may have more limited access to capital, but they continue to show historically high levels of high-quality capital. All segments have improved from pre-crisis levels." OCC National Risk Committee, *Semiannual Risk Perspective*, 5, 14, 25 (Spring 2012), *available at* http://occ.gov/publications/publications-by-type/other-publications-reports/semiannual-risk-perspective/semiannual-risk-perspective-spring-2012.pdf.

**FDIC:** "Insured institutions continued to build their capital in the second quarter . . . . At midyear, almost 97 percent of all insured institutions, representing more than 99 percent of insured institution assets, met or exceeded the requirements for 'well-capitalized' institutions as defined for Prompt Corrective Action purposes." FDIC, *Quarterly Banking Profile*, 3 (Second Quarter 2012), *available at* http://www2.fdic.gov/qbp/2012jun/qbp.pdf.

[6] *See* McKinsey & Company, *The Triple Transformation: Achieving a Sustainable Business Model*, 2 (Oct. 2012).

While supportive of improving the quality of bank capital and increasing the risk sensitivity of bank capital requirements, the Associations have serious concerns regarding the Agencies' proposals, including: (i) their lack of appropriate risk calibration; (ii) the timing of their implementation; (iii) their significant divergence from and additions to internationally agreed-upon capital standards (for example, the standardized approach under International Basel II[7]) and the absence of any comprehensive quantitative analysis to justify these deviations and additions; and (iv) their expected adverse impact on the availability of credit in a recovering U.S. economy and on the competitiveness of the U.S. banking system at home and abroad. These concerns are heightened by the cumulative impact of these proposals and other domestic and international financial regulatory reform efforts—including the Volcker Rule, comprehensive derivatives regulations, single counterparty exposure limits and other heightened supervisory requirements and prescriptive liquidity mandates, among others—which the Associations believe will severely hinder the ability of U.S. banking organizations to perform core financial intermediation functions, to provide credit to businesses, entrepreneurs and consumers and to serve as key facilitators of economic growth in the United States and around the world.

## General Comments and Recommendations

To ensure the proposed bank capital standards strengthen the U.S. banking system, without harming the economy or the ability of banks to serve their customers, the Associations respectfully recommend that:

- The Agencies should withdraw the Standardized Approach NPR to address its many problems and any re-proposal should be simplified and easier to follow and implement;
- The Agencies should conduct an empirical study of the impact on the U.S. banking system and bank customers resulting from the changes proposed to the current risk weight framework in the Standardized Approach NPR, the capital components of the Basel III Numerator NPR, and changes to the treatment of counterparty credit exposures in the Advanced Approaches NPR; and
- No banking organization should be required to comply with any changes to the existing bank capital framework sooner than one year after a final rule is published in the Federal Register. Moreover, additional time for compliance should be provided to community banks and savings and loan holding companies to allow them to adapt

[7] "**International Basel II**" refers to the international capital accord reached by the Basel Committee in *International Convergence of Capital Measurement and Capital Standards: A Revised Framework* (June 2006), *available at* http://www.bis.org/publ/bcbs128.pdf.

systems and access the capital markets as necessary in an orderly fashion and, in any event, the effective date for those institutions should be no earlier than July 21, 2015; and

- The Agencies should involve the state banking regulators as full participants in their deliberations and engage in closer consultation with Congress.

The Associations believe the proposals would have been more effective, with fewer negative consequences, if the Agencies had first conducted an empirical study of the impact of the proposals on all segments of the U.S. banking sector, bank customers and the broader U.S. economy. The Associations feel compelled to note that, notwithstanding the fundamental changes introduced in the proposals and their broad scope of application, the Agencies did not present any cost-benefit or other quantitative analysis of the proposals. The Associations urge the Agencies to perform, publish and invite comments on a comprehensive empirical study of the proposals, focusing on key areas such as the regulatory and economic impact, over time, of allowing unrealized gains and losses to "flow through" to a bank's common equity capital base and the proposed risk weights for residential mortgage exposures. Such an empirical study would help the Agencies assess whether aspects of the proposals are desirable in view of their impact on the provision of credit by all types of U.S. banking organizations and on the U.S. economy, as well as their effect on important indicators of industry competitiveness—for example, increased industry consolidation.

The Associations submit that the Basel Committee's quantitative impact study of International Basel III,[8] which is based on aggregate data from a relatively small sample of international banks,[9] is *not* an adequate substitute for the Agencies conducting a rigorous U.S.-specific empirical study of their proposals. First, the proposals would not only implement the capital requirements in International Basel III, but also impose, for the first time, a uniquely U.S. version of the standardized approach on all U.S. banking organizations. Second, as identified in this letter, the proposals differ in significant respects from internationally agreed-upon capital standards. Although certain of these differences are attributable to statutory mandates under the Dodd-Frank Act,[10] such as the Collins

[8] "**International Basel III**" refers to the international capital accord reached by the Basel Committee on Banking Supervision ("**Basel Committee**") in *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Revised June 2011), *available at* http://www.bis.org/publ/bcbs189.pdf.

[9] The Associations observe that of the 102 Group 1 banks (large and internationally active banks) surveyed in the Basel Committee's latest Basel III Monitoring Exercise, only 13 were U.S. banks. Moreover, none of the 107 Group 2 banks surveyed by the Basel Committee was a U.S. bank. *See* Basel Committee, *Results of the Basel III Monitoring Exercise as of 31 December 2011*, Table 1 (Sept. 2012), *available at* http://www.bis.org/publ/bcbs231.pdf.

[10] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010) ("**Dodd-Frank Act**").

Amendment in Section 171 and the prohibition against reliance on external credit ratings in Section 939A, others, such as the proposed risk weights for residential mortgage exposures, are not required by the Dodd-Frank Act or any U.S. statute.[11] The U.S.-specific empirical study recommended by the Associations would be a key step in assessing the economic impact and necessity of any divergent or additional provisions in the proposals that go beyond international capital standards. Moreover, such a study is especially important for community and regional banks which have not had the opportunity to engage with the Agencies over time to develop regulatory capital approaches supportive of their business models and customer base.

The limited amount of empirical data apparently available to the Agencies was noted by the Basel Committee in its preliminary Basel III regulatory consistency assessment of U.S. Basel III implementation efforts.[12] The Basel Committee's report stated that the Agencies had "provided limited quantitative data" and that, as a result, "directly estimating the impact of certain findings on the capital ratio of U.S. banks was not possible."[13] The Agencies provided some aggregated exposure data, but they were "generally based on information from five U.S. banks that represent almost 50 percent of the U.S. banking industry in terms of total assets."[14] In short, notwithstanding that the proposals are intended to apply to *all* U.S. banking organizations, the Agencies apparently relied primarily on data from a limited number of the largest U.S. banking organizations.[15]

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[11] As the Agencies themselves recently stated: "We recognise that sometimes countries cannot implement Basel Committee standards to the letter, but all members of the Committee should try their hardest to do so and, *when they cannot, they should be clear about the reasons why*." Basel Committee, *Basel III Regulatory Consistency Assessment (Level 2) Preliminary Report: United States of America*, Response from the U.S. Agencies (Oct. 2012) (emphasis added), *available at* http://www.bis.org/bcbs/implementation/l2_us.pdf.

[12] Basel Committee, *Basel III Regulatory Consistency Assessment (Level 2) Preliminary Report: United States of America* (Oct. 2012).

[13] *Id.* at 7.

[14] *Id.*

[15] The Basel Committee made the following additional observations regarding the Agencies' lack of data:

- "[I]ncomplete data has hampered the quantification process . . . ." *Id.* at 6.
- "For a number of findings no data was received and in those cases the materiality assessment is fully based on the team's qualitative judgement." *Id.*
- "The data provided by the U.S. agencies was not sufficient to adequately assess the actual and potential impact of this deviation from the Basel framework." *Id.* at 7.
- "No data were provided that compare the impact of the proposed U.S. standardised approach with that of the Basel II standardised approach." *Id.* at 9.

Instead of conducting their own comprehensive quantitative analysis, the Agencies have seemingly relied on general statements to justify the appropriateness of their proposals[16] and have placed the onus on the industry to provide data that support a different approach.[17] This shifting of responsibility does not seem to be consistent with sound regulatory policy or legal requirements. Due to confidentiality and other concerns (including the short comment period relative to the sweeping changes contemplated in the proposals), data provided by the industry in the context of the public comment process on the proposals may not be sufficiently comprehensive or granular to constitute a sufficiently rigorous assessment of the proposals. More work will be needed. The Agencies are institutionally positioned to gather industry-wide information, protect its confidentiality with respect to individual institutions and their customers, conduct the analysis and disseminate results to the public and the industry for further comment and review. Although such a data collection exercise could be burdensome to the industry, the Associations believe such a burden would be significantly outweighed by the benefit of a better calibrated and more risk-sensitive approach to revising the U.S. bank capital framework.

It is important, however, that the process of collecting and analyzing data be designed to ensure that the data are sufficiently granular and representative to permit an accurate assessment of the relationship between the individual components of the proposed capital standards and their impact on banking organizations' capital levels, liquidity, and other relevant metrics. To that end, the Associations recommend that they and their members be included in the process of designing the data collection and assessment process that would be integrated into the Agencies' empirical study.

In addition to the absence of a comprehensive quantitative analysis or empirical evidence to support the proposals—and perhaps as a result of this shortcoming—the proposals fail to account for the cumulative impact of other financial regulatory reforms, including those mandated by the Dodd-Frank Act, on U.S. banking organizations and their customers. Outside the United States, a primary regulatory deterrent against activities deemed "risky" is an unfavorable capital charge or a deduction from capital. In the United States, the Dodd-Frank Act introduces a plethora of provisions that prohibit, severely limit or heavily regulate a

[16] *See, e.g.*, Standardized Approach NPR ("Given the characteristics of the U.S. residential mortgage market and this recent experience, the agencies believe that a wider range of risk weights based on key risk factors is more appropriate for the U.S. residential mortgage market."); ("[T]he agencies do not believe that the risk profile of [securities] firms is sufficiently similar to depository institutions to justify that treatment."); ("The agencies believe that the proposed divergence in risk weights for category 1 and category 2 residential mortgage exposures appropriately reflects differences in risk between mortgages in the two categories."); ("Supervisory experience has demonstrated that certain acquisition, development, and construction (ADC) loan exposures present unique risks for which the agencies believe banking organizations should hold additional capital.").

[17] *See, e.g.*, Standardized Approach NPR, Question 5; Basel III Numerator NPR, Question 15.

broad range of banking and financial activities. However, rather than adjusting aspects of the bank capital framework to reflect the new regulatory landscape sculpted by Dodd-Frank, the Agencies have seemingly employed an overly conservative approach, seeking to impose almost wholesale Basel III (including a uniquely U.S. version of the standardized approach) *in addition to* and *contemporaneously with* the Dodd-Frank regulatory regime.

The Associations are deeply concerned that these cumulative burdens will place the U.S. banking sector at a significant competitive disadvantage domestically and internationally and reduce availability of credit and other financial services in the U.S. economy. The Dodd-Frank regulatory framework has already imposed significant costs on the industry. If the proposals were implemented without change and without careful consideration of the aggregate impact of financial reform on the U.S. banking sector, the Associations expect that many U.S. banking organizations will be forced to focus their activities on asset sales and retention of earnings, significantly impairing their ability to promote the growth of the U.S. economy. To avoid these undesirable consequences, the Associations urge the Agencies to revisit their proposals after quantitatively assessing the cumulative impact of bank capital and other financial reform regulations on the ability of U.S. banking organizations to provide financial services to consumers and businesses at this critical stage of economic recovery.

In addition to the proposals' substantive shortcomings, U.S. banking organizations of all sizes are concerned that the proposals would require them to meet new minimum capital ratios as early as calendar year 2013. The Associations believe it is unreasonable for the Agencies to propose a compliance timeline that mirrors International Basel III when the Agencies themselves did not issue the proposals until almost two years after International Basel III was officially adopted, nearly three years after International Basel 2.5[18] was completed and almost six years after the standardized approach under International Basel II was finalized. Until the proposals were issued, U.S. banking organizations were unable to adequately prepare for or react to a concrete U.S. implementation timeline, yet the Agencies have proposed an implementation timeline that would require U.S. banking organizations to comply with new capital rules beginning January 1, 2013. This is particularly true for community banks, which have not had the benefit of engagement with the Agencies during the International Basel II and International Basel 2.5 implementation process in the United States. A first glimpse at fundamental changes to the bank capital framework six months before compliance begins is unprecedented. Fundamental fairness requires that all U.S. banking organizations have a lead-time of more than a few months to bring themselves into compliance with the new capital rules, both substantively and operationally. The case for

[18] "**International Basel 2.5**" refers to the international capital accord reached by the Basel Committee in *Revisions to the Basel II Market Risk Framework* (July 2009, updated as of December 2010), *available at* http://www.bis.org/publ/bcbs193.pdf, and in *Enhancements to the Basel II Framework* (July 2009), *available at* http://www.bis.org/publ/bcbs157.pdf.

additional lead-time is also supported by the fact that implementation of International Basel III will likely be delayed in Europe as well as in other Basel Committee member countries.[19]

Accordingly, the Associations recommend that no banking organization should be required to comply with any changes to the existing bank capital framework sooner than one year after a final rule is published in the Federal Register. Moreover, additional time for compliance should be provided to community banks and savings and loan holding companies to allow them to adapt systems and access the capital markets as necessary in an orderly fashion and, in any event, the effective date for those institutions should be no earlier than July 21, 2015: an effective date that is warranted by the realities of the economy and is consistent with the Collins Amendment.

The deferral of the proposals' effective dates is justified by the disruptive impact that would otherwise be imposed on all U.S. banking organizations. First, internationally active banking organizations would be required, under the Agencies' interpretation of the Collins Amendment, to calculate minimum risk-based capital ratios using *both* the Advanced Approaches NPR and the Standardized Approach NPR to determine compliance with minimum risk-based capital requirements. This approach would require such organizations to spend enormous time and resources to compute both sets of ratios, yet deny them any potential benefit from using the more risk-sensitive internal models under the advanced approaches capital framework, to which they have already dedicated enormous time and resources to develop, calibrate, test, implement and monitor. In addition to the compliance costs associated with performing two sets of capital calculations, the Collins Amendment capital floor also removes incentives for internationally active banking organizations to develop enhanced internal methodologies that would better capture, monitor and manage risk and places them at a disadvantage compared to competitors that are not subject to U.S. bank capital requirements.

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[19] *See, e.g.*, UK Financial Services Authority, *FSA Statement Regarding CRD IV Implementation* (Aug. 2012), *available at* http://www.fsa.gov.uk/library/communication/statements/2012/crd-iv.shtml ("[I]t does not appear feasible that the [CRD IV] legislation can enter into force in line with the implementation date of 1 January 2013 as included in the original European Commission proposal of July 2011."); A. Huebner, *German Banks Gain Extra Six Months to Apply Basel Rules – Sources*, Reuters, Sept. 19, 2012 ("The Bundesbank and banking supervisor Bafin will give banks in Europe's largest economy until mid-2013, six months after the target starting date, to get reporting and controlling structures in place as well as adjust information technology systems."); Jim Brunsden, *EU Said to Consider Delay in Basel Rules for Up to a Year*, Bloomberg News, Oct. 12, 2012.

*See* Basel Committee, *Progress Report on Basel III Implementation* at 5-6 (Oct. 2012), *available at* http://www.bis.org/publ/bcbs232.pdf (indicating that, as of the end of September 2012, the vast majority of Basel Committee member countries (including the EU, Argentina, Brazil, Canada, Hong Kong, Indonesia, Korea, Mexico, Russia, South Africa, Turkey and the United States) have not yet published final rules to implement International Basel III).

Second, the proposals would exacerbate the funding challenges facing community and regional banks. The Basel III Numerator NPR would introduce significant volatility into U.S. banking organizations' capital by requiring unrealized gains and losses to flow through to common equity tier 1 capital. In addition, the Standardized Approach NPR would require all banks to substantially change the manner in which they collect and report information to calculate risk-weighted assets. Risk-weighted assets would increase dramatically and banks may consequently be forced to sell off and shrink their residential mortgage portfolios, thereby reducing the amount of credit available to borrowers. As a result of these proposed changes, many banks could be required to access the capital markets on short notice and in weak economic conditions. This would present a particular hardship on community banks, some of which have difficulty raising capital under even the best economic conditions.[20]

## Specific Comments and Recommendations

The Associations have carefully considered whether, among the many necessary revisions to the proposals, certain recommendations could be highlighted as being the most significant for the Agencies to consider. However, the diverse ways in which members of the Associations serve their customers means that the adverse impact of the proposals across all U.S. banking organizations could not be boiled down to a single list of the top five or ten priority items. Thus, virtually every issue identified in this letter has an impact on the ability of U.S. banking organizations to serve their customers and communities. Notwithstanding the diverse membership of the Associations, the members have found significant consensus and consistency in their concerns and recommendations regarding the proposals.

The following is an overview of the Associations' comments and recommendations regarding all three proposals:

### Basel III Numerator NPR

The Associations' comments and recommendations regarding the Basel III Numerator NPR are discussed in detail in **Annex A** and can be summarized as follows:

- The Agencies should not allow unrealized gains and losses on available-for-sale securities or defined benefit pension obligations to "flow through" to Common Equity Tier 1. *See* **Annex A Section II.A**.
- The Agencies should not require banking organizations to exclude from regulatory capital unrealized gains and losses on cash flow hedges that relate to the hedging of

[20] Moreover, unlike under the Dodd-Frank Act, the Basel III Numerator NPR would require community banks to exclude existing trust preferred securities from capital through a transition period beginning 2013.

items that are not recognized at fair value on the balance sheet. *See* **Annex A Section II.D**.

- The Agencies should make technical adjustments to the proposed eligibility criteria for Common Equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital. Without these technical changes, existing common stock issued by U.S. banking organizations may not fully satisfy the criteria for Common Equity Tier 1; existing preferred stock may not fully satisfy the criteria for Additional Tier 1 capital; and existing trust preferred securities may not fully satisfy the criteria for Tier 2 capital. *See* **Annex A Sections II.C, II.M** and **II.N**.

- The Agencies should grandfather capital instruments issued before May 19, 2010 by depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009, as expressly permitted by the Dodd-Frank Act. *See* **Annex A Section V.A**.

- The Agencies should revise the proposed phase-out schedule for non-qualifying capital instruments to align with the more gradual phase-out under International Basel III, to the extent permitted by the Collins Amendment. *See* **Annex A Section V.B**.

- The Federal Reserve Board should exercise its discretion to exempt small savings and loan holding companies with $500 million or less in consolidated assets from the Basel III Numerator NPR as well as the Standardized Approach NPR. *See* **Annex A Section I.B.3**.

- The Agencies should clarify that if a banking organization has the option to choose to net deferred tax liabilities against one of a number of asset types, the banking organization may make the same or a different choice from one reporting period to the next. The Agencies should also clarify that the netting of deferred tax liabilities is permitted against any asset that is subject to the corresponding deduction approach regardless of whether the banking organization's investment is in the form of common stock. *See* **Annex A Section II.F**.

- The Agencies should eliminate the existing 10 percent haircut for mortgage servicing assets, increase the proposed 10 percent deduction threshold for mortgage servicing assets to 25 percent (and recalibrate the proposed 15 percent aggregate deduction threshold accordingly to accommodate such an increase) and grandfather existing mortgage servicing assets. *See* **Annex A Section II.E**.

- The proposed rules governing minority interests should not limit the Tier 2 eligibility of subordinated debt issued by depository institutions, nor should they apply to qualifying real estate investment trust preferred securities. *See* **Annex A Section II.G**.

- The Agencies should narrow the proposed definition of "financial institution" in the context of the new regulatory deductions for investments in the capital of unconsolidated financial institutions by excluding, among others, Volcker covered funds, commodity pools and certain other investment funds, and ERISA plans. In addition, the predominantly engaged in financial activities prong of the Agencies' proposed definition of "financial institution" should be limited to financial companies designated as systemically important by the Financial Stability Oversight Council, which are by definition "predominantly engaged" in financial activities. *See* **Annex A Section II.I**.

- With respect to the proposed deduction for investments in the capital of unconsolidated financial institutions, the Agencies should amend the proposed netting restrictions to distinguish between trading book and banking book positions, given the significantly different nature and risk profile of these activities. The Agencies should exempt trading book positions from the deduction.[21] *See* **Annex A Section II.J**.

- Non-capital charges that do not impact regulatory capital should not be included in the definition of "eligible retained income" when determining limitations on dividend payments, capital distributions and executive compensation under the capital conservation buffer. *See* **Annex A Section III.A**.

- The proposed capital conservation buffer provisions would subject banks that have made an S Corporation tax election to a significant disadvantage compared to C Corporations. Specifically, if an S Corporation bank is profitable and meets its minimum capital requirements—but not the full capital conservation buffer—its shareholders will still be subject to tax on the bank's profits without receiving a cash distribution. *See* **Annex A Section III.A**.

- Consistent with International Basel III, the Agencies should carefully review and calibrate the supplementary leverage ratio before imposing it as a formal requirement on the largest and most internationally active banking organizations ("**advanced approaches banking organizations**"). *See* **Annex A Section IV.A**.

[21] However, if the Agencies are not inclined to exempt trading book positions, then "net long" exposures to the capital of unconsolidated financial institutions in the trading book should be determined using delta—an approach that is consistent with the Market Risk Final Rule.

## Standardized Approach NPR

The Associations' comments and recommendations regarding the Standardized Approach NPR are discussed in detail in **Annex B** and can be summarized as follows:

Although supportive of creating a more sensitive risk-based capital framework, the Associations have strong overall reservations regarding the Standardized Approach NPR. The Associations therefore recommend that the Agencies to take the following actions:

- Withdraw the Standardized Approach NPR to address its many problems and any re-proposal should be simplified and easier to follow and implement;
- Conduct an empirical study of the changes proposed to the current risk weight framework in the Standardized Approach NPR, focusing in particular on the necessity of changing residential mortgage risk weights in light of other pending proposals to tighten mortgage underwriting standards;
- Provide for the following in any re-proposal of the Standardized Approach NPR:
    - Reduce the risk weight mismatch among asset classes;
    - Recognize that performing loans are less risky than nonperforming loans; and
    - Re-calibrate the maximum risk weight so that it does not exceed the value of the asset.

The Associations believe that empirical analysis of actual and relative risks in the residential mortgage market is especially important because the proposed risk weights deviate significantly from international capital standards and would have substantial, detrimental effects on the U.S. housing market, the relationship between banks and government-sponsored entities and the competitiveness of the U.S. banking system.

If the Agencies re-propose the Standardized Approach NPR, the Associations recommend that any such re-proposal should, with respect to residential mortgage exposures:

- Grandfather legacy mortgage exposures to reduce regulatory burden and data constraints. *See* **Annex B Section IV.B.4**;
- Provide for a simpler approach that distinguishes between first and junior liens. *See* **Annex B Section IV.B.1**;
- Evaluate first and junior lien mortgages separately so that a junior lien does not "taint" the first lien, unless the junior lien is originated and funded at the same time as the first lien in a "piggyback" loan. *See* **Annex B Section IV.B.2**;

- Clarify that the credit conversion factor applies to the unfunded portion of a held residential mortgage exposure for purposes of calculating the numerator of the loan-to-value ratio. *See* **Annex B Section IV.B.3**;

- Recognize sustainable loan modifications and restructurings, whether or not they are a part of the Home Affordable Modification Program. *See* **Annex B Section IV.B.5**;

- Recognize private mortgage insurance at both the individual and the pool-wide level. *See* **Annex B Section IV.B.6**; and

- Maintain the 120-day safe harbor for credit-enhancing representations and warranties in the current risk-based capital rules. *See* **Annex B Section IV.B.7**.

The Associations also have substantial concerns with other important aspects of the Standardized Approach NPR that are not related to residential mortgages and recommend that any re-proposal should:

- Exclude less risky commercial real estate loans from the definition of high volatility commercial real estate, and tier high volatility commercial real estate risk weights according to loan-to-value ratio. *See* **Annex B Section V**;

- Treat exposures to securities firms that meet certain comparability requirements in the same manner as exposures to depository institutions, *i.e.*, assigning a 20 percent risk weight. *See* **Annex B Section VI**;

- Reduce the risk weight applicable to past due exposures because the proposed 150 percent risk weight double-counts the capital allocation for delinquent loans, to the extent of charge-offs and loan loss reserves taken on such loans. *See* **Annex B Section VII**;

- Adopt the internal models methodology to determine the exposure amount for over-the-counter derivative contracts for banking organizations that receive supervisory approval (consistent with the international Basel capital framework) and, for all other banks, recognize netting to a greater extent (consistent with International Basel III) and apply a 15 percent haircut to the exposure calculation under the current exposure method. *See* **Annex B Section VIII.B**;

- Continue to allow any banking organization that does not use the internal models methodology as a permitted alternative to the current exposure method (as recommended above) to apply the 50 percent risk weight ceiling for exposures to over-the-counter derivative contracts. *See* **Annex B Section VIII.C**;

- At a minimum, implement the Basel Committee's interim framework regarding capital requirements for bank exposures to central counterparties, with the Agencies continuing to actively participate in the Basel Committee's ongoing efforts in this area. *See* **Annex B Section IX**;

- Rather than require each individual banking organization to demonstrate that a particular central counterparty satisfies the qualitative criteria under the proposed qualifying central counterparty definition, the Agencies should coordinate with other regulators to develop a definitive list of qualifying central counterparties on which banking organizations could rely for regulatory capital purposes. *See* **Annex B Section IX.A**;

- Permit a qualifying central counterparty's hypothetical capital requirement ($K_{CCP}$) to be calculated, with regulatory approval if necessary, using risk-sensitive internal models or other appropriate methodologies instead of the current exposure method, which was introduced nearly a quarter of a century ago. *See* **Annex B Section IX.B**;

- Incentivize banking organizations to act as intermediaries and provide access to central counterparties for their clients by allowing the capital charge for the client-facing legs of cleared transactions to reflect a lower exposure amount or lower risk weight. *See* **Annex B Section IX.D**;

- Eliminate the 20 percent risk weight floor applicable to collateralized transactions. *See* **Annex B Section X.A**;

- Adopt a market-based haircut approach for collateralized transactions in place of the proposed standard supervisory haircut approach or, at the very least, recognize credit quality and maturity in the standard supervisory haircut approach. *See* **Annex B Section X.C;**

- Continue to allow banks to use supervisory-approved simple value-at-risk methodologies to calculate exposures to repo-style transactions and eligible margin loans. *See* **Annex B Section X.C**;

- Revise the overly broad definition of securitization to focus on the tranching and pooling of risk and revise the definition of resecuritization to exempt *de minimis* resecuritizations and resecuritizations of senior tranches of a single underlying security. *See* **Annex B Section XI.A** and **Section XI.B**;

- Make the simplified supervisory formula approach more risk-sensitive by, among other things, adopting a flexible approach to data inputs; recognizing underlying asset quality, performance, and recovery rates; and recognizing soft credit support in determining the attachment point for securitization exposures. *See* **Annex B Section XI.E**;

- Grandfather legacy residential mortgage exposures for purposes of securitization calculations. *See* **Annex B Section XI**;

- Reduce the risk weight assigned to publicly traded equity exposures. *See* **Annex B Section XII.A**; and

- Adopt a simpler approach for private securitization exposures held by certain eligible investment funds that prevents regulatory arbitrage. *See* **Annex B Section XII.B**.

**Advanced Approaches NPR**

The Associations' comments and recommendations regarding the Advanced Approaches NPR are discussed in detail in **Annex C** and can be summarized as follows:

- Consistent with International Basel III, the credit valuation adjustment capital requirement should be calculated on a portfolio basis and not on a counterparty-by-counterparty basis. *See* **Annex C Section II.A**.

- Consistent with the heightened risk sensitivity of the advanced approaches, banking organizations should be allowed to apply a materiality standard in determining whether or not to increase the assumed holding period or margin period of risk upon the occurrence of certain enumerated events. *See* **Annex C Section I**.

- The credit valuation adjustment capital requirement should not apply to over-the-counter derivatives with central banks (such as the Federal Reserve Banks), multilateral development banks and similar counterparties that have very low credit risk. *See* **Annex C Section II.C.**

- The Associations' comments and recommendations regarding the proposed capital treatment of cleared transactions and exposures to the default funds of central counterparties—set forth in the Standardized Approach NPR section of this letter—are equally applicable to the substantively identical provisions in the Advanced Approaches NPR. *See* **Annex C Section III** and **Annex B Section IX**.

- The Associations' comments and recommendations regarding the definitions of "securitization" and "resecuritization," the proposed 1,250 percent risk weight for certain securitization exposures, the calibration of the simplified supervisory formula approach and the proposed due diligence requirements for securitization exposures—set forth in the Standardized Approach NPR section of this letter—are equally applicable to the substantively identical provisions in the Advanced Approaches NPR. *See* **Annex C Section IV** and **Annex B Section XI**.

- Where there are immaterial gaps in the data required for the supervisory formula approach for securitization exposures, the Agencies should permit an advanced approaches banking organization to use proxy data, provided it represents a conservative estimate of actual data. *See* **Annex C Section IV.C**.

- With respect to the proposed due diligence requirement for securitization exposures, the Agencies should permit an advanced approaches banking organization to make a reasonable materiality assessment in the event that it is not able to obtain all of the necessary information to satisfy each due diligence item prior to acquisition of the exposure and in any event within three business days. *See* **Annex C Section IV.G**.

- In light of ongoing industry and regulatory developments, particularly those under the Dodd-Frank Act that are aimed at reducing the interconnectedness among systemically important financial institutions, such as the single counterparty exposure limits, the Agencies should reconsider the necessity of introducing, in the United States, a uniform multiplier to the correlation factor formula with respect to exposures to certain financial institutions.[22] *See* **Annex C Section V.B**.

- The proposed definition of "eligible guarantor" represents a fundamental departure from the international Basel capital framework and would significantly narrow, without any apparent justification, the types of persons whose guarantees a banking organization could recognize for credit risk mitigation purposes under the risk-based capital framework. *See* **Annex C Section V.D**.

- The Agencies should carefully consider the implications of their proposed revisions to the banking book capital rules on trading book positions that will migrate to the banking book as a result of the new, narrower definition of "covered position" in the Market Risk Final Rule.[23] *See* **Annex C Section VI**.

In addition, the empirical study that the Agencies should conduct prior to issuing any final rule should address the impact of all of the proposed changes to measuring counterparty credit risk exposures in the Advanced Approaches NPR, as well as the impact of the Standardized Approach NPR as the proposed Collins Amendment floor, on the availability and cost of credit and other services provided by advanced approaches banking organizations.

[22] However, should the Agencies decide to implement an asset value correlation multiplier in the United States, they should, at a minimum: (i) address the overly broad definition of "financial institution" in a manner consistent with the Associations' recommendations in the context of the proposed capital deductions for investments in unconsolidated financial institutions; and (ii) ensure that the asset value correlation multiplier is applied to the Correlation Factor formula for *non*-HVCRE wholesale exposures, *i.e.*, $(0.12 + \mathbf{0.12} \times e^{-50 \times PD})$ and *not* to the Correlation Factor formula for HVCRE exposures, $(0.12 + \mathbf{0.18} \times e^{-50 \times PD})$.

[23] OCC, Federal Reserve Board and FDIC, *Risk-Based Capital Guidelines: Market Risk*, 77 Fed. Reg. 53,060 (Aug. 30, 2012) ("**Market Risk Final Rule**").

*  *  *  *

The Associations thank the Agencies for considering the comments and recommendations set forth in this letter. If you have any questions or need further information, please do not hesitate to contact:

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# ANNEX A

## Basel III Numerator NPR: Comments and Recommendations

## I. Threshold Issues

### A. Application of the Basel III Numerator NPR to the U.S. Banking Industry

The Basel III Numerator NPR would apply to all U.S. banking organizations.[1] The broad application of the Basel III Numerator NPR to the entire U.S. banking industry has the potential to cause significant disruptions to the banking industry and the overall economy.

As a general matter, the Basel III Numerator NPR fails to account for the cumulative impact of significant revisions to the international Basel capital framework (including International Basel III, International Basel 2.5 and the capital surcharge for global systemically important banks) and additional reforms, restrictions and prohibitions imposed by the Dodd-Frank Act that both strengthen safety and soundness and reduce systemic risk. The Associations are very concerned that these cumulative burdens will reduce credit availability in the U.S. economy and place the U.S. banking system at a competitive disadvantage internationally. The Dodd-Frank regulatory framework has already imposed significant costs on the industry. If the Basel III Numerator NPR were implemented as drafted, the Associations expect that many U.S. banking organizations will be forced to focus their activities on asset sales and retention of earnings, significantly impairing their ability to support the growth of the U.S. economy and decreasing the global competitiveness of the U.S. banking system.

The Associations are also concerned that if the Federal Reserve Board, as it apparently intends, supplements the Basel III Numerator NPR with a subsequent proposal to implement a quantitative capital surcharge based on the Basel Committee's framework for global systemically important banks ("**G-SIBs**") and/or the Basel Committee's framework for domestic systemically important banks ("**D-SIBs**"), the largest U.S. banking organizations could potentially become subject to a combined Common Equity Tier 1 ("**CET1**") ratio of 12 percent or more,[2] reflecting the cumulative imposition of a quantitative surcharge in addition

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[1] These include all national banks, state member banks, state nonmember banks, state and federal savings associations and top-tier bank holding companies domiciled in the United States not subject to the Federal Reserve Board's Small Bank Holding Company Policy Statement, 12 C.F.R. Part 225 Appendix C, as well as top-tier savings and loan holding companies domiciled in the United States, regardless of size.

[2] *See* Basel Committee, *A Framework for Dealing with Domestic Systemically Important Banks - Final Document*, Principle 10 (Oct. 2012), *available at* http://www.bis.org/publ/bcbs233.pdf ("Home authorities

*(continued)*

to the baseline CET1 and the capital conservation and countercyclical capital buffers. The Associations believe that U.S. banking organizations should not be subject to the capital conservation and countercyclical buffers and an additional quantitative surcharge, and that imposing all three simultaneously would be unnecessary. To do so would be to impose capital requirements far beyond what is required to limit systemic risk and promote a safe and prudent banking system, resulting in increased borrowing costs for customers and decreased lending to the communities that these institutions serve.

### B. Implementation Timing

#### 1. Application to U.S. Banking Organizations

U.S. banking organizations of all sizes are concerned that the Basel III Numerator NPR would require them to meet new minimum capital ratios as early as calendar year 2013. The Associations believe it is unreasonable for the Agencies to propose a compliance timeline that mirrors International Basel III when the Agencies themselves did not issue the Basel III Numerator NPR until almost two years after International Basel III was officially adopted. Until the proposals were issued in June 2012,[3] U.S. banking organizations were unable to prepare for or react to a concrete U.S. implementation timeline, yet the Agencies have proposed an implementation timeline that would require U.S. banking organizations to comply with new capital rules beginning January 1, 2013. Fundamental fairness requires that banking organizations have a lead-time of more than a few months to bring themselves into compliance with the new minimum capital rules. The case for additional lead time is also supported by the fact that European regulators recently indicated that implementation of International Basel III in Europe will be delayed. Accordingly, the Associations believe it is unrealistic and inconsistent with recent international developments to expect all U.S. banking organizations to be able to comply with new minimum capital ratios by calendar year 2013.

Accordingly, the Associations recommend that no banking organization should be required to comply with any changes to the existing bank capital framework sooner than one year after a final rule is published in the Federal Register.

#### 2. Application to Community Banks

The Associations note that community banks in particular will face significant difficulties in meeting the proposed new minimum capital requirements by calendar year 2013. International Basel III was only intended for "internationally active" banks; therefore

should impose the higher of either the D-SIB or G-SIB [higher loss absorbency] requirements in the case where the banking group has been identified as a D-SIB in the home jurisdiction as well as a G-SIB.").

[3] The proposals were not published in the Federal Register until August 30, 2012.

many U.S. banking organizations, including community banks, did not expect that it would apply to them.[4] The reshuffling of the capital categories, which will see the exclusion of traditional sources of capital from CET1, will prove particularly burdensome to community banks, as they cannot change their capital composition as quickly or easily because of more limited access to capital markets. As a result, community banks may be forced to shrink their balance sheets in a scramble to comply with the new enhanced capital requirements by 2013. This reduction in balance sheet size may lead to a concomitant decrease in lending activity, with the result that consumers and small businesses, which constitute the majority of community bank customers, will be harmed by reduced availability of credit.

The Associations believe that some of these potential negative impacts may be avoided if the Agencies provide community banks additional time to comply with new capital standards. This would allow community banks time to adapt systems and, if necessary, access the capital markets in an orderly fashion. In any event, the effective date of any final rule for community banks should be no earlier than July 21, 2015.

The Associations believe that deferred implementation would be consistent with legislators' and the Agencies' stated intent, expressed numerous times and in a variety of contexts, to promote, protect and preserve community banks.[5] Without appropriately targeted implementation on the part of the Agencies, the community banking infrastructure as it currently exists in the United States may be significantly harmed.

### 3. Application to Savings and Loan Holding Companies

The Basel III Numerator NPR provides that all SLHCs, regardless of size, would be subject to new minimum capital ratios beginning calendar year 2013. In contrast, the Basel III Numerator NPR provides that U.S. bank holding companies ("**BHCs**") that are subsidiaries of foreign banking organizations and rely on the Federal Reserve Board's Supervision and Regulation Letter SR 01-01 ("**SR 01-01 Entities**") would not be required to comply with the proposed capital requirements under any of the proposals until July 21, 2015.

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[4] *See, e.g.*, Basel Committee, *Report to G20 Leaders on Basel III Implementation*, 14-16 (June 2012), *available at* http://www.bis.org/publ/bcbs220.pdf (explicitly directing the international Basel capital framework at "internationally active" banks and noting that "Basel Committee member countries are not required, therefore, to apply the framework to all their banks").

[5] *See, e.g.*, Ben S. Bernanke, *Community Banking* (Mar. 14, 2012), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20120314a.htm (noting that community banks are a "critical component" of the financial system that "keep their local economies vibrant by taking on and managing the risks of local lending"). *See also* Letter from 53 United States Senators to Federal Reserve Board Chairman Ben Bernanke, Comptroller of the Currency Thomas Curry and Acting Chairman of the FDIC Martin Gruenberg (Sept. 27, 2012), *available at* http://www.scribd.com/doc/107164458/Warner-Toomey-letter-urging-protection-for-community-banks.

The Agencies note specifically in the preamble to the Basel III Numerator NPR that the proposed treatment of SR 01-01 Entities is "[c]onsistent with the Dodd-Frank Act."[6]

It is unclear to the Associations why the Agencies have granted SR 01-01 Entities the benefit of the clear exemptive language in the Collins Amendment but have chosen not to grant SLHCs the benefit of similarly clear exemptive language. Section 171(b)(4)(D), which provides that SLHCs are not subject to the Collins Amendment until July 21, 2015, and Section 171(b)(4)(E), which grants similar relief to SR 01-01 Entities, are virtually identical, reflecting Congress's clear intent that *neither* SLHCs nor SR 01-01 entities should be subject to risk-based capital and leverage requirements until July 21, 2015.

The Associations do not believe that the Agencies are compelled to apply the capital requirements wholesale to SLHCs in the manner set forth in the Basel III Numerator NPR and Standardized Approach NPR. To the contrary, the Associations believe strongly that Section 171(b)(4)(D) of the Dodd-Frank Act reflects the clear intent of Congress that SLHCs not be subject to consolidated capital requirements until July 21, 2015, and that the Agencies have ample authority under Section 171(b)(4)(D) to refrain from imposing such capital requirements on SLHCs until that date.

Accordingly, the Associations believe that the Federal Reserve Board should take congressional intent into account with respect to SLHCs (as it has with respect to SR 01-01 Entities) and should provide SLHCs additional time to comply with new capital standards. This would allow SLHCs to build the required processes, adapt systems and, if necessary, access the capital markets in an orderly fashion. In any event, the effective date of any final rule with respect to SHLCs should be no earlier than July 21, 2015.

Further, the Associations recommend that the Federal Reserve Board exercise its discretion to exempt small SLHCs with $500 million or less in consolidated assets from the Basel III Numerator NPR and the Standardized Approach NPR. The Basel III Numerator NPR and Standardized Approach NPR exempt small BHCs with $500 million or less in consolidated assets, and the Federal Reserve Board has had a long-standing policy of exempting small BHCs from capital rules. The exemption is based on the fact that typically the only activity of a small BHC is the holding of the stock or controlling interest in the bank that is subject to capital rules. Similarly, because the activities of small SLHCs are generally limited to ownership or control of the subsidiary savings association, it makes little sense for a small SLHC to be subject to the Basel III Numerator NPR and Standardized Approach NPR simply because of the type of charter that its subsidiary holds.

[6] Basel III Numerator NPR at 52,795.

## II. Definition of Capital

Below, the Associations offer their specific comments on elements of the Basel III Numerator NPR relating to the proposed new minimum capital ratios, including deductions from and adjustments to the components of regulatory capital.

### A. Unrealized Gains and Losses on Available-for-Sale Securities

Under the current risk-based capital rules, unrealized gains and losses on available-for-sale ("**AFS**") debt securities (except for those caused by other-than-temporary credit impairments) are not included in regulatory capital.[7] The Basel III Numerator NPR,[8] however, proposes the "flow through" to CET1 of all unrealized gains and losses on a banking organization's AFS securities, thereby removing the accumulated other comprehensive income ("**AOCI**") filter.[9] The Agencies acknowledge in the preamble to the Basel III Numerator NPR that removing the AOCI filter would likely (i) add "substantial" volatility to U.S. banking organizations' capital ratios as these gains and losses are often temporary; and (ii) discourage U.S. banking organizations from holding a pool of high-quality liquid assets for liquidity risk management purposes.[10] The Associations share these concerns and further note that the removal of the AOCI filter would create other unintended consequences, including balance sheet distortions. For these reasons, which are discussed in detail below, the Associations strongly believe that the current AOCI filter should be maintained. The Associations also urge the Agencies to bear in mind regulatory changes currently being considered by the Basel Committee and others that will affect bank AFS securities pools. In addition to the liquidity framework being finalized by the Basel Committee, the Financial Accounting Standards Board ("**FASB**") and the International Accounting Standards Board ("**IASB**") are currently evaluating the accounting treatment of securities portfolios under U.S. generally accepted accounting principles ("**GAAP**") and

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[7] Currently, unrealized losses on AFS equity securities are included in Tier 1 capital and unrealized gains on AFS equity securities are partially included in Tier 2 capital.

[8] In Question 16 of the preamble to the Basel III Numerator NPR, the Agencies requested comments on the impact of a requirement to include unrealized gains and losses in capital on (i) regulatory capital volatility; (ii) liquid asset levels; (iii) the composition of a bank's securities portfolio; and (iv) asset and liability management.

[9] Current capital rules exclude unrealized gains and losses on AFS debt securities from regulatory capital. The use of the term "filter" in the context of AOCI refers to this exclusion. The Associations believe that the Agencies propose to remove the AOCI filter only with respect to AFS securities. Under current U.S. GAAP, effective from the first quarter of 2009, certain unrealized losses within held-to-maturity securities may be recorded within AOCI. The Associations believe the AOCI filter should be maintained for both AFS and held-to-maturity securities.

[10] Standardized Approach NPR at 52,811.

International Financial Reporting Standards ("**IFRS**"). Any revisions to the treatment of AOCI should be based on a full and complete assessment of the results of such deliberations.

### 1. Removal of the AOCI Filter Would Hinder the Ability of U.S. Banking Organizations to Effectively Engage in Sound Risk Management Practices

The Associations believe that risk management should be a holistic endeavor, with capital management strategies aligned with those of interest rate and liquidity risk management. Removing the AOCI filter, however, would have an asymmetric and adverse impact on the ability of U.S. banking organizations to manage interest rate and liquidity risk. For instance, banking organizations typically hold large quantities of high-quality AFS debt securities to hedge against the interest rate risk associated with fixed-rate deposit liabilities, which are not marked to fair value for accounting purposes. Banking organizations will likely respond to the removal of the AOCI filter by significantly reducing or shortening the duration in AFS debt securities. This, in turn, would make it more difficult for banking organizations to align the duration of assets with the duration of liabilities, match funding terms with assets or structure their balance sheet mixes to effectively offset interest rate risk mismatches.

Removal of the AOCI filter would also distort actual interest rate risk and lead to market confusion about the true capital position and economic value of a banking organization. For example, the interest rate sensitivity stress tests on net income and economic value of equity ("**EVE**") employed today often show that banking organizations benefit from rising interest rates (due to how deposits and other liabilities are structured in relation to assets). However, under the Agencies' proposal, unrealized losses on a banking organization's AFS portfolio will have a significant adverse impact on its capital in a rising interest rate environment.

Moreover, because removal of the AOCI filter would cause a banking organization's value to be understated in rising interest rate environments and overstated in a falling interest rate environment, a banking organization could be perceived as weak by the market at a time when its earnings and value are in fact strong. For example, in a rising interest rate environment, flow through of AOCI to capital could decrease a banking organization's capital, even though the value and profitability of a banking organization may have increased. As a result, a banking organization could potentially be classified as less than well-capitalized even though—because of interest rate changes—its EVE has increased and its net interest margin has presumably also increased. By the same token, removal of the AOCI filter could allow temporary unrealized gains to inflate a banking organizations' capital ratios.

In addition to managing interest rate risk, banking organizations also hold AFS securities in their bond portfolios to manage liquidity risk. Typically, the securities used to mitigate liquidity risk are those that are most sensitive to interest rate fluctuations. To the extent these fluctuations flow through to CET1 as a result of the proposed removal of the AOCI filter, banking organizations' ability to manage liquidity will be constrained. In other words, removal of the AOCI filter pits capital adequacy directly against liquidity adequacy. These unintended consequences also appear to run counter to recent efforts by the Agencies, the Basel Committee and other international regulators to strengthen interest rate and liquidity risk management at banks.

If the AOCI filter were removed, then, in order to manage interest rate risk and liquidity risk, U.S. banking organizations would need to hold capital of some undetermined amount in excess of the new minimum capital ratios, the capital conservation buffer and (if applicable) countercyclical buffer. The removal of the AOCI filter would therefore impose a new, *de facto* AOCI capital buffer with which banking organizations must comply to ensure their capital levels do not unpredictably dip below the capital conservation buffer and, if applicable, the countercyclical buffer. Moreover, the *de facto* buffer is a moving target. Since there is no limit to the size of a potential AOCI deduction in capital, it is possible that a banking organization would never be able to maintain a sufficiently large AOCI capital buffer.

### 2. Removing the AOCI Filter Would Significantly Increase the Volatility of Regulatory Capital

The Associations understand the Agencies' desire to make the numerator of a banking organization's risk-based capital ratios more reflective of actual risk. However, it is inconsistent with that goal to introduce into regulatory capital a highly volatile component that is—as the Agencies themselves acknowledge—largely reflective of changes in interest rates.

Although the immediate practical consequences of the increased volatility of regulatory capital are not yet completely evident because of the current, abnormally low interest rate environment, the negative impact of removing the AOCI filter would eventually ripple through the entire U.S. banking system. Even today, some U.S. banking organizations are taking steps to prepare for the removal of the AOCI filter in a rising interest rate environment, in particular by shortening the duration of their investment portfolios by, among other measures, limiting investments in 30-year Fannie Mae and Freddie Mac mortgage-backed securities ("**MBS**") and buying shorter-term U.S. Treasury securities. When interest rates increase in the future, banking organizations, in response to the removal of the AOCI filter, may refrain from purchasing municipal debt securities (which tend to have longer maturities), thereby increasing borrowing costs for municipalities and decreasing liquidity in the municipal debt markets. U.S. banking organizations are proceeding cautiously in taking such actions, but this should not be taken as a sign that the actual impact of removing the AOCI filter in a rising interest rate environment will be either modest or manageable.

The Associations' analysis, based on data from consolidated reports of condition and income ("**Call Reports**"), indicates that, if the AOCI filter were removed, many U.S. banking organizations could potentially fall below the well-capitalized standard in a rising interest rate environment.[11] This reduction of capital resulting from mark-to-market losses would not be indicative of safety and soundness issues or inadequate coverage for market risk because the banking organization's other assets and liabilities are not marked-to-market. **Table A-1** shows the number of U.S. banks that could fall short of the Agencies' proposed well-capitalized standard under different interest rate scenarios and assuming a bond portfolio duration of 3.[12]

**<u>Table A-1</u>: Number of U.S. Banks Potentially Falling Below the Proposed Well-Capitalized Standard If the AOCI Filter Were Removed***

| Interest Rate | Number of U.S. Banks Potentially Falling Short of: | | | | Percentage of Non-Compliant Banks |
|---|---|---|---|---|---|
| | 5% Tier 1 Leverage Ratio | 8% Tier 1 Capital Ratio | 10% Total Capital Ratio | At Least One Ratio | |
| Current | 171 | 198 | 240 | 408 | 6% |
| 100 bps | 186 | 208 | 257 | 437 | 6% |
| 200 bps | 213 | 229 | 302 | 506 | 7% |
| 300 bps | 275 | 263 | 381 | 639 | 9% |
| 400 bps | 421 | 358 | 553 | 942 | 13% |
| 500 bps | 660 | 574 | 896 | 1475 | 20% |
| 600 bps | 976 | 901 | 1326 | 2119 | 29% |

* Assuming bond portfolio duration of 3.
**Source:** Call Report data and analysis performed by the Associations

[11] In addition to the Associations' analysis, a recent paper estimated that if the AOCI filter were removed and if interest rates were to increase by 300 basis points, community banks' regulatory capital levels would decrease by approximately 20 percent, a decrease based on the impact of temporary impairments in investment portfolios that likely will remain unrealized. In this paper, the Balance Sheet Analytics Group at Sandler O'Neill + Partners reviewed the potential exposure on the AFS investment portfolios of more than 7,000 banking organizations with total assets of less than $50 billion. *See* Thomas W. Killian, Sandler O'Neill + Partners, L.P., *U.S. Basel III Capital Rules – Broad Application with Substantial Increase in Complexity and Required Capital*, Appendix I (June 21, 2012), *available at* http://www.sandleroneill.com/Collateral/Documents/English-US/NPR%20Summary%20Final.pdf.

[12] The Associations have conducted similar analysis using a number of different duration assumptions and have categorized the results based on bank asset size. The American Bankers Association will submit additional materials containing such analysis concurrently with the submission of this letter.

### 3. At a Minimum, the Treatment of AOCI Should Be Considered in Light of the Liquidity Coverage Ratio and Other Changes to Liquidity-Related Regulatory Frameworks

At a minimum, the Agencies should defer the possible removal of the AOCI filter until finalization of expected rules to implement, in the United States, the Liquidity Coverage Ratio ("**LCR**") under the International Basel III Liquidity Framework[13] and potential changes to other liquidity-related regulatory frameworks. The interaction between the Basel III Numerator NPR and the LCR is not susceptible to effective evaluation by either the Agencies or the industry at this time. Moreover, in view of the proposed qualitative liquidity requirements in Regulation YY,[14] it is likely that many banking organizations will hold a pool of securities for liquidity purposes, with the International Basel III Liquidity Framework's stock of high-quality liquid assets as a benchmark. Therefore, the removal of the AOCI filter will have significant ramifications for liquidity risk management. The Associations believe it is crucial that the AOCI filter be retained, at the very least, for those high-quality liquid assets that ultimately are determined to be LCR-eligible (without limitation).[15]

For these reasons, the Associations recommend that the Agencies defer the possible removal of the AOCI filter until finalization of any rules to implement the LCR and potentially other liquidity management regulations so that the Agencies and the industry will have an opportunity to fully consider their interactions and combined ramifications.

### 4. If Treated as an Adjustment to Regulatory Capital, AOCI Resulting from Interest Rate Risk Should Be Excluded

If, despite the foregoing, the Agencies determine to implement the removal of the AOCI filter without delay, the Agencies should provide that unrealized gains and losses predominantly resulting from changes in interest rate risk—which are therefore generally temporary in nature[16]—would not flow through to CET1. In other words, the Agencies

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[13] *See* Basel Committee, *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 2010), *available at* http://www.bis.org/publ/bcbs188.pdf ("**International Basel III Liquidity Framework**").

[14] Federal Reserve Board, *Enhanced Prudential Standards and Early Remediation Requirement for Covered Companies (Regulation YY)*, 77 Fed. Reg. 593 (Jan. 5, 2012).

[15] As currently calibrated, the LCR is defined as the ratio of a banking organization's stock of high-quality liquid assets to its total net cash outflows over the next 30 calendar days. *See* International Basel III Liquidity Framework ¶ 16.

[16] Current U.S. GAAP requires institutions to determine whether there is Other Than Temporary Impairment ("**OTTI**") to a security any time the security's fair value is less than its amortized cost amount. The portion of OTTI that is related to a credit loss (or, because of liquidity requirements of the bank, will be realized because of a likely sale) is recorded through net income, and thus is not presented as "unrealized." The

*(continued)*

should, at the very least, adopt an approach that adjusts CET1 primarily in response to credit risk, but not interest rate risk. Such an approach would, for practical purposes, greatly reduce the burden and potential for undesirable interactions between the Basel III Numerator NPR and the LCR. In particular, the Associations strongly believe that, if the Agencies decide to move forward with certain adjustments to the AOCI filter, then unrealized gains and losses resulting from U.S. government and agency debt obligations and U.S. government-sponsored entity ("**GSE**") debt obligations, and obligations guaranteed as to principal and interest by a U.S. agency or GSE (such as GSE-guaranteed MBS) should continue to be excluded from regulatory capital. These securities are of the type that should qualify as Level 1 high-quality liquid assets for LCR purposes.[17]

Recognizing that the OECD Country Risk Classifications ("**CRC**")-based approach to risk-weighting of foreign sovereign obligations is imperfect, the Associations also believe that certain foreign sovereign obligations which pose comparatively low risk should also be considered for exclusion, and that the Agencies should seek to develop a framework that appropriately distinguishes low risk foreign sovereign obligations from other foreign sovereign obligations. In addition, to reduce negative externalities on the capital management of municipalities resulting from re-pricing of municipal debt securities in response to the differing capital treatment of municipal debt securities and the debt securities of other U.S. governmental entities, the Associations would also support excluding unrealized gains and losses resulting from municipal debt securities.

### 5. Pension-Related Actuarial Unrealized Gains and Losses Should Also Be Excluded from Capital

Another example of the distortions created by removing the AOCI filter pertains to obligations under defined benefit pension plans. Pension obligation AOCI represents the difference between pension assumptions and actual experiences during a given year. Pension obligation AOCI is predominantly influenced by the discount rate assumptions used to determine the value of the plan obligation. The discount rate is tied to prevailing interest rates at one point in time each year, typically a lightly traded period in December. While market returns on the underlying assets of the plan and discount rates may fluctuate year to year, the underlying liabilities are typically longer term—in some cases 15 to 20 years. Therefore, prevailing point in time rate environments can lead to very material fluctuations in unrealized

remaining portion—the amount remaining in AOCI—predominantly represents a true temporary market-based difference that will not be realized. Even as the FASB proceeds to implement changes to impairment accounting, this aspect of GAAP is not expected to change significantly.

[17] As noted above, to the extent other assets are ultimately determined to be Level 1 high-quality liquid assets for LCR purposes, the Associations believe that unrealized gains and losses on such assets should also be excluded from regulatory capital.

gains and losses. Removing the AOCI filter on pension liabilities could lead to material swings in capital. To the extent these swings in capital could contribute to a reduction in CET1, some banking organizations could consider winding down their defined benefit pension plans as a means of reducing their exposure to capital volatility.[18]

Notwithstanding the foregoing, if the Agencies decide to remove the AOCI filter, then, at a minimum, the Agencies should allow banking organizations to determine the value of their pension obligation using the "Accumulated Benefit Obligation" ("**ABO**") calculation instead of the "Projected Benefit Obligation" ("**PBO**") calculation. ABO does not take into account potential future compensation increases. The Agencies should allow banking organizations to exclude the effects of future compensation increases from the capital calculation because it is highly unlikely that such increases would be realized in the event a banking organization becomes distressed or is placed in receivership.

* * *

For all of the above reasons, the Associations believe it is wholly inappropriate to eliminate the AOCI filter. Unrealized gains and losses on AFS securities should have no impact on a banking organization's capital management other than to the limited extent reflected in the current risk-based capital rules. The Associations therefore urge the Agencies to fully analyze the consequences of removing the AOCI filter, including by accounting for the current, abnormally low interest rate environment and, importantly, the potential for interest rates to increase in the near to medium term.

### B. Impact of Changes in Accounting Standards

The impact of the proposed new minimum capital ratios and regulatory deductions and adjustments must be properly analyzed in the context of evolving accounting standards. As the Agencies are aware, accounting standards have a significant impact on how banking organizations record and report assets on their balance sheets and thus have a significant impact on the overall regulatory capital positions of banking organizations. As the Agencies evaluate and implement the Basel III capital framework in the United States, the Associations request that the Agencies also focus on promoting the consistent international accounting treatment of various assets and interact and consult with accounting standard-setting bodies as appropriate to achieve this objective. In particular, the Agencies should focus on consistent net capital requirements, based on higher allowances expected to be recorded on loan and

[18] Removal of the AOCI filter could have a disproportionate impact on certain types of banking organizations. For example, mutual organizations do not have stock or stock options to offer their employees; as a result, many use pension plans to attract and retain talent. Defined benefit pension plans allow mutual organizations to compete in the marketplace for talented employees. Their ability to compete for such talent could be severely undermined by the removal of the AOCI filter.

security impairments, and the international accounting treatment of various financial instruments.

The Associations are concerned that ongoing deliberations by the FASB and the IASB regarding the accounting treatment of securities portfolios under GAAP and IFRS may lead to inconsistent treatment of these portfolios between U.S. and foreign jurisdictions, such that U.S. banking organizations may be competitively disadvantaged. In particular, the Associations understand that changes in accounting standards resulting from these deliberations could potentially require U.S. banking organizations to record unrealized gains and losses that not only exceed current levels, but also exceed gains and losses required to be recorded by non-U.S. banking organizations operating under IFRS. Thus, the negative impact resulting from the AOCI filter's removal would be exacerbated.

With this in mind, the Associations request that the Agencies assess the impact of proposed changes to the accounting treatment of securities portfolios under GAAP and IFRS on the regulatory capital positions of U.S. banking organizations. If it is determined that such changes could disadvantage the U.S. banking sector competitively, any action taken by the Agencies with respect to the AOCI filter should include steps to mitigate such negative competitive impacts.

### C. Common Equity Tier 1—Proposed Eligibility Criteria

Consistent with International Basel III, the Basel III Numerator NPR contemplates that U.S. banking organizations will be subject to a new minimum CET1 capital ratio. The Agencies state that the new CET1 ratio is designed to ensure that banking organizations hold capital that is truly loss-absorbing. The Associations have consistently supported efforts to improve the loss-absorption capability of capital to ensure capital levels are commensurate with risk. Although supportive of a heightened focus on common equity, the Associations have significant concerns with various aspects of the proposed adjustments to CET1, which are discussed in detail below.

In the preamble to the Basel III Numerator NPR, the Agencies state that most existing common stock instruments previously issued by U.S. banking organizations fully satisfy the proposed criteria for CET1 capital. Although the Associations appreciate this statement of intent, they are nevertheless concerned that certain of the proposed CET1 criteria could potentially present issues for most U.S. banking organizations' outstanding common stock. First, criterion (v) would require that any cash dividends on a CET1 instrument be paid out of a banking organization's net income and retained earnings and not be subject to limits imposed by contractual terms governing the instrument. The Associations request clarification that cash dividends also may be paid out of "surplus," as "surplus" is included within the dividend test under Delaware law and generally under U.S. corporate law.[19] Given that many U.S. BHCs are incorporated in Delaware or are incorporated in states that follow Delaware corporate law, the Associations request clarification that common stock instruments that permit dividends to be paid out of surplus qualify as CET1 instruments.

In addition, criterion (vii) would require that dividend payments and any other capital distributions on the CET1 instrument be paid only after *all* legal and contractual obligations of the banking organization have been satisfied, including payments due on more senior claims. This criterion could be read as preventing a banking organization from paying a dividend simply because of minor and immaterial delays in paying trade creditors in the ordinary course of business, the existence of a bona fide dispute regarding a matured obligation, or even the existence of obligations that have yet to mature. The Associations therefore recommend the removal of criterion (vii).

Finally, Section ___.20(b)(1)(iii) of the Basel III Numerator NPR states that, in order to qualify as CET1, an instrument must include language that the instrument "can only be redeemed via discretionary repurchases with the prior approval of the [Agency]." The Associations do not disagree with this requirement; however, the Associations note that many outstanding common stock instruments do not contain such language. Therefore, the Associations suggest that the Agencies create a freestanding prior approval requirement and do not require that prior approval language be included in the instrument itself.

### D. Treatment of Cash Flow Hedges

Under the Basel III Numerator NPR, banking organizations would be required to deduct any unrealized gain and add any unrealized loss on cash flow hedges included in AOCI to CET1, net of applicable tax effects, that relate to the hedging of items not recognized at fair value on the balance sheet. The Associations are concerned that this proposed deduction would have a particularly negative impact in light of the proposed adjustments to the AOCI filter and would negatively affect a proven and reliable tool that banking organizations have used for years to manage interest rate risk in a safe and sound manner. Many banking organizations use cash flow hedges to hedge short-duration liabilities on their balance sheets, such as interest rate-related liabilities from bond portfolios, and would have greater difficulty implementing these hedges under the proposed approach. The result of the proposed deduction would therefore be a reduction in the amount of cash flow hedges used to improve risk management and therefore the safety and soundness of the institution, which could potentially lead to increased interest rate risk in the banking system. Because of the expected decrease in the usage of cash flow hedging, the proposed change is expected to

[19] This request applies equally to Additional Tier 1 criterion (vii), which also requires that capital distributions be paid out of "net income and retained earnings."

reduce CET1 among banking organizations below $50 billion by between $1.5 billion and $17.5 billion.[20] When taken together with the proposed removal of the AOCI filter, the quantitative and qualitative impact would be even more significant. The Associations submit that by contractual (and counterparty) design, cash flow hedges present little or no economic risk to a banking organization. In light of the potential for increased interest rate risk and the potential inconsistency with the safety and soundness-enhancing nature of the activity, the Associations request that the Agencies eliminate this proposed deduction.

### E. Mortgage Servicing Assets

Under the Basel III Numerator NPR, mortgage servicing assets ("**MSAs**") includable in regulatory capital would decrease from the current 100 percent of Tier 1 to 10 percent of CET1,[21] which would be a significant reduction for those banking organizations with retail mortgage servicing operations. The Basel III Numerator NPR would also impose an overall limitation of 15 percent of CET1 on the combined balance of includable MSAs, deferred tax assets ("**DTAs**") and investments in the common stock of unconsolidated financial institutions. Furthermore, Section 475 of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("**FDICIA**") already imposes a 10 percent haircut on the fair market value of readily marketable MSAs that banking organizations may include in regulatory capital.[22] That 10 percent haircut is preserved by Section ___.22(d)(3) of the Basel III Numerator NPR with respect to that part of a banking organization's MSAs that do not exceed the 10 percent and 15 percent limitations. In addition, the Standardized Approach NPR would impose a 250 percent risk weight on MSAs not deducted from CET1.[23]

In sum, three exceptionally stringent regulatory capital requirements would apply simultaneously to MSAs under the proposed rules: a full deduction from CET1 for that amount of MSAs exceeding the 10 percent and 15 percent limits; a 10 percent haircut for that amount of MSAs not exceeding the limits; and a 250 percent risk weight for MSAs not deducted from CET1. This treatment of MSAs is yet another example of the Agencies' "worst of all worlds" approach—applying the most conservative aspects of the International Basel III framework without making any adjustment to an existing U.S. framework that

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[20] Thomas W. Killian, Sandler O'Neill + Partners, L.P., *U.S. Basel III Capital Rules – Broad Application with Substantial Increase in Complexity and Required Capital*, Appendix I (June 21, 2012).

[21] Under the Basel III Numerator NPR, a banking organization would calculate the 10 percent CET1 deduction threshold by taking 10 percent of the sum of a banking organization's CET1 elements, *less* adjustments to, and deductions from CET1 required under Sections ___.22(a) through (c) of the Basel III Numerator NPR.

[22] 12 U.S.C. § 1828 note.

[23] Standardized Approach NPR § ___.32(l)(4).

already includes unique provisions tailored to address the unique risk factors associated with MSAs.

In fact, the proposed 250 percent risk weight for MSAs that are not deducted from regulatory capital *in and of itself* would be more burdensome for banking organizations than the existing U.S. capital framework (10 percent FDICIA haircut and 100 percent risk weight). For purposes of illustration, assume that a banking organization must have an 8 percent total capital to total risk-weighted assets ratio to be adequately capitalized. Under the existing framework, institutions must hold capital equivalent to 17.2 percent of the MSAs they hold (consisting of the 10 percent FDICIA haircut, plus 8 percent of the remaining 90 percent of MSA value). Under the Basel III Numerator NPR, if the 10 percent FDICIA haircut were eliminated, MSAs would incur a minimum capital requirement of 20 percent (8 percent of 100 percent of MSA value times the 250 percent risk weight). Under the Basel III Numerator NPR, including the 10 percent FDICIA haircut, MSAs would result in a minimum capital requirement of 28 percent (the 10 percent FDICIA haircut plus 8 percent times the 250 percent risk weight on 90 percent of MSA value), representing a 62 percent increase over the existing capital requirement. These examples assume that none of the banking organization's MSAs is deducted from CET1 because the total amount of MSAs exceeds the 10 percent limit or (together with DTAs and investments in the common stock of unconsolidated financial institutions) exceeds the 15 percent limit set forth in Section ___.22 of the Basel III Numerator NPR. If any amount of the bank's MSAs were subject to this deduction, the capital impairment associated with MSAs would obviously be even more severe.

As a result of the proposed capital deductions, the existing 10 percent FDICIA haircut, and the proposed 250 percent risk weight for amounts not deducted, banking organizations would be significantly more inclined to sell mortgage loans with servicing rights released to the acquirer—which would likely result in a significantly greater proportion of the mortgage servicing business migrating to less-regulated, higher-cost non-bank mortgage servicers. This would have a large and disproportionate impact on banking organizations, including community banks, which maintain the servicing rights on mortgage loans they sell to maintain customer relationships. Many of these customer relationships have been developed over long periods of time and should not be penalized by the new, punitive treatment of MSAs.

To avoid these adverse consequences, the Agencies should eliminate the existing 10 percent FDICIA haircut, increase the proposed 10 percent deduction threshold for MSAs to 25 percent and grandfather existing MSAs.

First, because of the much more stringent treatment of MSAs resulting from International Basel III, the Agencies should eliminate the 10 percent haircut adopted pursuant to the pre-existing regulatory regime applicable to MSAs. Section 475 of FDICIA—the source of the existing requirement—allows MSAs to be valued at more than 90 percent of their fair market value if the Agencies jointly find that such valuation would not have an adverse effect on the deposit insurance funds or the safety and soundness of insured depository institutions. Given the cumulative effect of the proposed rules on the regulatory capital treatment of MSAs, and the fact that even without the 10 percent FDICIA haircut MSAs would nevertheless incur a higher capital impairment under the proposed rules than they do currently with the haircut, the Agencies should permit a banking organization to include 100 percent of the fair market value of its readily marketable MSAs and remove Section ___.22(d)(3) of the Basel III Numerator NPR.

Second, banking organizations should be permitted to hold up to 25 percent of CET1 in MSAs. The Agencies should also recalibrate the proposed 15 percent aggregate deduction threshold to accommodate the greater recognition of MSAs in CET1. The proposed 10 and 15 percent limitations appear to be based on the notion that MSAs are intangible assets that, like goodwill or DTAs, would not be available to absorb losses in the event that a banking organization holding them were to become distressed. That characterization simply does not apply to MSAs. Because of the robust mortgage securitization market in the United States, the market for MSAs is also robust. In the United States, MSAs are readily valued and can be sold in the open market even when the banking organization holding them is in distress—just as a banking organization can sell other types of assets such as loans or securities. Moreover, unlike other intangible assets, servicers generally realize the value of MSAs in the United States because GSEs provide certain guarantees and incentives for loss mitigation that reduce potential losses. Thus, in the U.S. context, the 10 percent and 15 percent limitations on MSAs are simply inappropriate. These limitations also have the effect of unduly penalizing the U.S. model for mortgage delivery (securitization) when compared with the model used in most other countries (originate and hold).

Finally, the regulatory capital treatment of MSAs existing as of the effective date of the Basel III Numerator final rule should be grandfathered. The proposed treatment is so much more stringent than the current treatment—and the rules would be changed so significantly—that fundamental fairness calls for the imposition of the new rules prospectively, rather than retroactively. It is unlikely that banking organizations would have developed deep positions in retained servicing rights if they had known that their ability to include MSAs in regulatory capital would be so sharply curtailed. In addition, the Agencies have provided no empirical evidence to support the conclusion that these existing MSAs—especially ones relating to seasoned mortgages that have thus far survived the worst of the mortgage crisis—are so risky that they warrant a much higher, retroactively imposed charge for regulatory capital.

### F. Netting of Deferred Tax Liabilities Against Assets Subject to Deduction

The Associations request clarification with respect to two ambiguities regarding the netting of deferred tax liabilities ("**DTLs**") against assets subject to deduction. First, where a banking organization has the option to choose to net DTLs against one of a number of asset types, the Basel III Numerator NPR should clarify that the banking organization may make either the same or a different choice from one reporting period to the next. Section ___.22(e)(1) of the Basel III Numerator NPR provides that netting of DTLs is permitted against assets subject to deduction under Section ___.22 (such as goodwill, DTAs arising from operating loss and tax credit carryforwards and MSAs) subject to certain conditions, including that the DTL is associated with the asset and would be extinguished if the asset became impaired or was derecognized under GAAP. Section ___.22(e)(3) imposes additional restrictions on netting DTLs against DTAs arising from operating loss and tax credit carryforwards in particular, including that such DTLs may not have been netted against assets subject to deduction under Section ___.22(e)(1). The Associations request that the Agencies more explicitly confirm that, if a banking organization has (for example) elected to net DTLs against MSAs in one reporting period, in the following reporting period it may nevertheless elect to net such DTLs (that would otherwise be permissible to net against MSAs) against any other permissible asset type, such as DTAs arising from operating loss and tax credit carryforwards, in accordance with Section ___.22(e)(3). Similarly, the Agencies should confirm that banking organizations subject to the Federal Reserve Board's capital plan rule and Comprehensive Capital Analysis and Review ("**CCAR**") process may choose to net DTLs against different assets in different economic scenarios, provided that all applicable requirements in Section ___.22 are met.

Second, the Associations request confirmation that, assuming the conditions in Section __.22(e) are met, a banking organization may determine the amount of any non-significant investment in the capital of an unconsolidated financial institution or of any significant investment in the capital of an unconsolidated financial institution that is not in the form of common stock that is subject to the corresponding deduction approach under Sections __.22(c)(4) and (c)(5), respectively, net of any associated DTLs. Although the language in Sections 22(c)(4) and (c)(5) does not specifically provide for netting, Section __.22(e) provides that the netting of DTLs is permitted against any asset that is subject to a deduction under Section ___.22.

### G. Minority Interests and Real Estate Investment Trust Preferred Capital

While the Agencies' proposed treatment of minority interests (capital issued by consolidated subsidiaries not owned by the banking organization) is generally consistent with International Basel III, the Associations are concerned that such treatment would have significantly more adverse effects on capital instruments issued by U.S. depository institutions than those issued by foreign depository institutions. This is because a U.S. depository institution is typically controlled by a holding company, while in many foreign jurisdictions the depository institution itself tends to be the top-tier legal entity. With this background, the Associations have the following specific concerns with respect to the Agencies' proposed treatment of minority interests.

### 1. Application to Bank-Issued Subordinated Debt

The Associations are particularly concerned that the practical effect of the proposed minority interest rules will be to limit the Tier 2 eligibility of subordinated debt issued by depository institutions. Although it may have been the Basel Committee's intent to limit the eligibility of depository institution debt in this manner, the Associations believe that this approach fails to account for the importance of subordinated debt to the capital structures of depository institutions and the protection it provides to bank depositors and senior creditors, as compared to other capital instruments (such as cumulative perpetual preferred stock). Additionally, for many banking organizations, the bank subsidiary constitutes nearly *all* of the institutions' assets and operations, negating any purpose in limiting the inclusion of subordinated debt of subsidiaries (particularly bank subsidiaries) through the minority interest rules. Furthermore, applying the proposed minority interest rules to bank-issued instruments would appear to incentivize institutions to hold less capital since the more excess capital is held, the less capital can be included at the consolidated level. Because depository institution subsidiaries often constitute the majority of the consolidated institution's assets and liabilities, capital is already located where losses could potentially be incurred.

### 2. REIT Preferred Capital

While the Associations appreciate that the Basel III Numerator NPR reconfirms the viability of real estate investment trust preferred stock ("**REIT preferred**") as an acceptable form of regulatory capital, the restrictions on the amount of REIT preferred that can be counted in any particular tier of capital are highly complex and likely to eliminate any substantial use of REIT preferred as an attractive form of capital that can be of any real benefit to most banking organizations. Moreover, as the Agencies acknowledge in the Basel III Numerator NPR, noncumulative perpetual preferred REIT securities include an exchange feature that gives a bank's primary federal supervisor the right to cause the conversion of the REIT preferred into noncumulative perpetual preferred stock of the parent banking organization under certain conditions, including (i) if the banking organization becomes undercapitalized or is placed into conservatorship or receivership; or (ii) the banking organization's primary federal supervisor, in its sole discretion, anticipates either (1) taking supervisory action that limits the bank's ability to pay dividends; or (2) that the banking organization will become "undercapitalized" in the near term. Because this exchange feature ensures that REIT preferred securities will be able to absorb losses at the consolidated level, the Associations do not believe it is appropriate to apply the minority interest limitations to qualifying REIT preferred securities.

REITs must distribute 90 percent of their earnings in order to maintain the beneficial tax status that makes them attractive investments. The requirement that a REIT preferred issuer have the ability to either cancel dividends or declare a consent dividend (*i.e.*, a dividend not actually paid to holders, but nevertheless reported by holders as taxable income despite retention by the issuer) in order to include a portion of such REIT preferred in Tier 1 capital is likely to significantly reduce the viability of REIT preferred as an attractive investment to potential purchasers. The requirement to be able to pay a consent dividend is especially onerous for securities that contain a dividend stopper. The Associations believe that the effectiveness of a consent dividend is negated in these cases, as the banking organization would be unable to pay a consent dividend to common shareholders if the preferred dividend was eliminated. The Associations request that the Agencies clarify their intent in requiring that a REIT preferred issuer have the ability to declare a consent dividend, especially in circumstances where a dividend stopper exists. The Associations also seek confirmation that a REIT would be considered an "operating entity" for purposes of the proposed eligibility criteria for Additional Tier 1 and Tier 2 capital instruments.[24]

For these reasons, if the Basel III Numerator NPR were adopted as proposed, as a practical matter, REIT preferred seems highly unlikely to continue to be a viable form of capital for U.S. banking organizations. The Associations believe that all instruments which are exchangeable at the banking supervisor's discretion, such as REIT preferred, should be excluded from the minority interest calculations and included in consolidated Additional Tier 1 capital of the banking organization.

**H. Goodwill**

Although the Basel III Numerator NPR preserves existing deductions for goodwill, including goodwill embedded in the valuation of significant investments in unconsolidated financial institutions, it differs from International Basel III in that these deductions would be immediately applicable in 2013, whereas International Basel III phases in the deduction of goodwill from 2014 through 2018. Although the existing deduction of goodwill is a statutory requirement (at least as applied to insured depository institutions),[25] this disparity between International Basel III and the regulatory treatment of U.S. institutions is yet another example of the many ways in which the overlay of the most conservative aspects of the Dodd-Frank Act and the existing U.S. regulatory regime with the most conservative aspects of International Basel III will, in the aggregate, subject the U.S. banking system to a significant competitive disadvantage internationally. To alleviate some of these competitiveness issues,

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[24] *See* Basel III Numerator NPR at 52,817; § ___.2 (defining "operating entity"); § ___.20(c)(xiii); § ___.20(d)(xi).

[25] *See* 12 U.S.C. § 1828(n).

the Associations urge the Agencies to ease aspects of the Basel III Numerator NPR that are not statutorily required to be as conservative as, or more conservative than, International Basel III.

## I. Investments in the Capital of Unconsolidated Financial Institutions

The Basel III Numerator NPR would require banking organizations to deduct investments in the equity instruments of unconsolidated "financial institutions" that in the aggregate exceed 10 percent of the sum of the banking organization's CET1 elements after accounting for certain deductions required by the Basel III Numerator NPR. The deduction would be phased in beginning in 2013, with a 100 percent deduction required by 2018.

For purposes of this deduction, an "investment" is a net long position in an instrument that is recognized as capital for regulatory capital purposes and would include direct, indirect, and synthetic exposures to such instruments, excluding underwriting positions held by a banking organization for five business days or less. For large banking organizations with diverse balance sheets, the deduction could have a significant impact on regulatory capital, given the expansive definition of "financial institution" in the Basel III Numerator NPR, which includes not only banks and BHCs but also any entity "predominantly engaged" in a variety of financial activities.

The Associations recognize the underlying policy rationale of the deduction, which is to reduce so-called "double counting" of capital and interconnectedness among financial institutions. The Associations are concerned, however, that, as formulated in the Basel III Numerator NPR, the proposed deduction is unnecessarily expansive, would result in certain unintended consequences, and would be particularly problematic, perhaps even unworkable, from an implementation perspective for large banking organizations with respect to indirect exposures to financial institutions.

### 1. Definition of "Financial Institution"

The Basel III Numerator NPR defines "financial institution" very broadly to include not only depository institutions, foreign banks, depository institution holding companies, insurance firms and securities firms, but also commodity pools, covered funds for purposes of Section 13 of the Bank Holding Company Act of 1956 (the "**Volcker Rule**"), ERISA plans, and other companies that are "predominantly engaged" in a wide range of financial-related activities. The proposed definition is broad and would include both regulated and unregulated entities. In addition, the "predominantly engaged" prong of the definition would impose significant operational burdens on banking organizations, which would be forced to examine the revenues and assets of their counterparties and equity holdings.

The Associations respectfully submit that the exposures to many of the entities encompassed within the proposed definition can be more appropriately managed as risk-weighted assets rather than as capital deductions. In addition, a narrower definition of "financial institution" would better reflect the text of International Basel III, which requires deductions only for investments in "banking, financial and insurance entities," not for investments in funds, commodity pools, ERISA plans or entities that are otherwise "predominantly engaged" in financial activities.[26] A narrower definition of "financial institution" would also promote international consistency and reduce risks of regulatory arbitrage, as the EU's proposed implementation of International Basel III defines "financial institution" more narrowly.[27]

Accordingly, the Associations recommend that, for purposes of the capital deduction, the definition of "financial institution" should be limited to: (i) insured depository institutions (including banks, thrifts and credit unions); (ii) depository institution holding companies (including BHCs and SLHCs); (iii) non-bank financial companies designated by the Financial Stability Oversight Council ("**FSOC**") under Section 113 of the Dodd-Frank Act (which by definition includes entities that are "predominantly engaged" in financial activities); (iv) insurance companies; (v) securities holding companies (as defined in Section 618 of the Dodd-Frank Act); (vi) foreign banks; (vii) securities firms (including U.S. broker-dealers); (viii) futures commission merchants; and (ix) swap dealers and security-based swap dealers. Discouraging extensive cross-holdings of these institutions' equity instruments would appropriately guard against financial contagion and systemic risk, while avoiding the negative consequences of an over-broad standard.

Under the Associations' definition, the following entities, among others, would not be included in the definition of "financial institution": (i) Volcker Rule covered funds and other funds that register under, or rely on exemptions from, the Investment Company Act of 1940; (ii) commodity pools; and (iii) ERISA plans. These entities are not within the scope of the "financial institution" definition as contemplated by International Basel III[28] and do not raise

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[26] *See* International Basel III at ¶ 80.

[27] *See* European Commission, *Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms*, Art. 4(3) (Definitions) (July 20, 2011), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0452:FIN:en:PDF ("**CRD IV Regulation**").

[28] *See* Basel Committee, *Basel III Definition of Capital - Frequently Asked Questions*, Paragraphs 78–89 (Investments in own shares, investments in the capital of banking financial and insurance entities and threshold deductions), Question 7 (Dec. 2011), *available at* http://www.bis.org/publ/bcbs211.pdf ("[E]xamples of the types of activities that financial entities might be involved in include financial leasing, issuing credit cards, portfolio management, investment advisory, custodial and safekeeping services and other similar activities that are ancillary to the business of banking.").

the same concerns associated with interconnectedness and the double-counting of capital as the regulated entities that would be encompassed by the Associations' proposed definition.

Unlike International Basel III, the Basel III Numerator NPR defines "financial institution" to include any company that is "predominantly engaged" in financial activities. As proposed, this "predominantly engaged" standard would impose a new, burdensome requirement on banking organizations to analyze the revenue and assets of their counterparties and equity holdings to determine the required deductions. The Associations recognize the Agencies' concerns regarding interconnectivity and systemic risk and respectfully suggest that application of this prong of the definition be limited to financial companies designated as systemically important by the FSOC, which, under Title I of the Dodd-Frank Act, are by definition "predominantly engaged" in financial activities.[29]

Two reasons support limiting the definition in this respect. First, requiring a banking organization to evaluate its entire portfolio of investments and equity holdings, and to apply an assets and revenue test to each entity within these portfolios, would create an extremely burdensome administrative requirement, one that would be especially burdensome for large banking organizations with diverse holdings across a wide range of companies. In many instances, smaller companies may not publicly report their revenue and asset profiles, which would impose informational limitations on banking organizations' ability to apply a standard with no asset threshold. The underlying goal of the proposed deduction, including limiting interconnectedness risk that may present systemic concerns, can be more efficiently addressed by limiting the kinds of companies covered by the deduction in the manner the Associations suggest. Companies covered by the deduction would include any non-bank financial company that may be part of the shadow banking system that the FSOC has determined may pose a threat to financial stability due to the company's interconnectedness or other systemic factors.

Second, to the extent that cross-holdings of regulatory capital instruments among large U.S. financial institutions present systemic risk, the Associations submit that these risks are separately addressed by other international regulatory initiatives[30] and, in the United States, the systemic regulation framework under the Dodd-Frank Act. Numerous provisions in the Dodd-Frank Act, including single-counterparty credit limits, resolution planning requirements, the Title II orderly resolution provisions and enhancements to bank lending limits, among others, are intended to guard against systemic risk and reduce concerns about

[29] *See* Dodd-Frank Act § 102(a)(4) (defining designated non-bank financial companies as companies that are "predominantly engaged in financial activities," as defined in section 102(a)(4) of the Dodd-Frank Act).

[30] *See, e.g.*, Basel Committee, *Global Systemically Important Banks: Assessment Methodology and the Additional Loss Absorbency Requirement, Rules Text* (Nov. 2011), *available at* http://www.bis.org/publ/bcbs207.pdf.

banking organizations' balance sheet exposures to capital issued by financial institutions. Collectively, these enhanced prudential requirements and structural reforms will reinforce credit risk protections and ensure that systemic risk associated with exposures to financial institutions' equity instruments is effectively managed.

### 2. Volcker Rule Covered Funds

The Associations are particularly concerned that the Agencies' proposed definition of "financial institution" includes any entity that is deemed a covered fund for purposes of the Volcker Rule. As a threshold matter, the Associations note that covered funds are squarely outside the scope of the term "banking, financial and insurance entities" as interpreted by the Basel Committee in the context of International Basel III's deductions for investments in the capital of unconsolidated financial institutions. In fact, investment funds were not included in the Basel Committee's examples of the types of entities that could be considered financial institutions.[31] Moreover, an entity's status as a covered fund for purposes of the statutory text of the Volcker Rule depends on the particular exemption from registration that it relies on under the Investment Company Act of 1940, and covered funds generally do not engage in any of the illustrative activities identified by the Basel Committee.

The Volcker Rule itself provides for covered banking organizations to deduct only one type of covered fund investment from regulatory capital and requires such a deduction only if the Agencies make certain findings. Specifically, Section 13(d)(4)(B)(iii) of the Volcker Rule requires that a banking organization deduct the amount of its investment in hedge funds and private equity funds made under the so-called asset management exception in Section 13(d)(1)(G) of the Volcker Rule from its assets and tangible equity, and that the amount of deduction must increase in an amount commensurate with the leverage of the fund. In proposed rules to implement the Volcker Rule, the Agencies proposed to require banking organizations to deduct from Tier 1 capital the aggregate value of investments in hedge funds and private equity funds that the banking organization organizes and offers pursuant to Section 13(d)(1)(G) of the Volcker Rule.

The Associations believe that any deduction for investments in a covered fund should be limited to those investments that Congress, in the Volcker Rule itself, suggested might warrant a deduction from capital. Moreover, as discussed in recent comments on the Volcker Rule proposed implementing regulations, a necessary precondition for any proposed regulatory capital deduction for investments in a covered fund made under the exception in Section 13(d)(1)(G) is the determination required under Section 13(d)(3) of the Volcker Rule

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[31] Basel Committee, *Basel III Definition of Capital - Frequently Asked Questions,* Paragraphs 78–89 (Investments in own shares, investments in the capital of banking financial and insurance entities and threshold deductions), Question 7 (Dec. 2011), *available at* http://www.bis.org/publ/bcbs211.pdf.

that "additional capital requirements" are necessary to protect the safety and soundness of the banking system.[32] In other words, before requiring any regulatory capital deductions for investments in covered funds, even for those investments made under Section 13(d)(1)(G), Section 13(d)(3) of the Volcker Rule requires that the Agencies first make a determination that additional capital requirements are necessary to promote safety and soundness and then impose such capital requirements through the normal rulemaking process.

The Associations do not believe that the Agencies can or should make the determination required by Section 13(d)(3) of the Volcker Rule that a capital deduction for covered fund investments made under Section 13(d)(1)(G) (much less any other type of covered fund) is necessary to protect the safety and soundness of the banking system. In this regard, the Volcker Rule itself already limits the aggregate amount of investments that a banking entity may make under Section 13(d)(1)(G) to no more than 3 percent of the entity's Tier 1 capital. Moreover, the proposals already adequately address the regulatory capital treatment of equity investments in covered funds. For example, the proposals would expand to all banking organizations the existing Simple Modified Look-Through and Alternative Modified Look-Through Approaches for risk-weighting exposures to investment funds, and provide for an additional Full Look-Through Approach (pursuant to which a banking organization would risk-weight exposures to an investment fund as if it owned the fund directly), which currently applies only to advanced approaches banking organizations. These approaches, for example, would assign a 400 percent risk weight to an investment made by a banking entity in a fund that was invested exclusively in non-public equities.

Finally, the Associations respectfully submit that under no circumstances should banking organizations be required to make capital deductions for investments in covered funds during the Volcker Rule's statutory conformance period. The conformance period is mandated by the statutory Volcker Rule and is, as recognized by the Federal Reserve Board, "intended to give markets and firms an opportunity to adjust to the prohibitions and requirements of that section and any implementing rules adopted by the agencies."[33] Banking organizations must be permitted a meaningful opportunity to reallocate investments in covered funds, and requiring deductions during the conformance period could result in significant capital deductions that would apply only temporarily before banking organizations exited investments in funds by the end of the conformance period. These temporary

[32] *See* Letter from the Securities Industry and Financial Markets Association, American Bankers Association, The Financial Services Roundtable and The Clearing House Association to the OCC, Federal Reserve Board, FDIC, CFTC and SEC (Feb. 13, 2012), *available at* http://www.sifma.org/workarea/downloadasset.aspx?id=8589937355.

[33] Federal Reserve Board, *Statement of Policy Regarding the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*, 77 Fed. Reg. 33,949 (June 8, 2012).

deductions may disrupt banking organizations' efforts to redeploy capital into other asset or investment classes and would not meaningfully increase protection against systemic risk or interconnectedness, as banking organizations would by definition be divesting their interests in covered funds.

### 3. Clarifications Related to Capital Deductions

The Associations seek clarification regarding other provisions in the Basel III Numerator NPR relating to deductions for investments in unconsolidated financial institutions. As drafted, these provisions are unclear about the scope of capital instruments covered and the application of netting arrangements.

The Basel III Numerator NPR defines an "investment in the capital of an unconsolidated financial institution" to be, in relevant part, "a net long position in an instrument that is recognized as capital for regulatory purposes . . . including direct, indirect and synthetic exposures to capital instruments . . . ."[34] The definition explains how to calculate a "net long position" by deducting short positions from the gross long position and includes specific rules for index positions. As drafted, the definition of "investment" (i) covers all regulatory capital instruments; (ii) includes direct, indirect and synthetic exposures; (iii) incorporates netting rules; and (iv) addresses index positions.

It is unclear, however, how the definition relates to the definitions of "significant investment in the capital of unconsolidated financial institutions" and "non-significant investment in the capital of an unconsolidated financial institution." In contrast with the above definition, these definitions (i) cover only "issued and outstanding common shares," not all regulatory capital instruments; (ii) are silent on the treatment of direct, indirect and synthetic exposures; (iii) are silent regarding the treatment of netting long and short positions; and (iv) do not address index positions.[35]

The rules in Section ___.22 of the Basel III Numerator NPR governing deductions from regulatory capital present further confusion. There, the deduction for a non-significant investment in the capital of an unconsolidated financial institution applies to "common shares" rather than to "issued and outstanding common shares," as in the definition. Similarly, the deduction for "significant investments in the capital of unconsolidated financial institutions that are not in the form of common stock" refers to common stock rather than to "issued and outstanding common shares," as in the definition.

[34] Basel III Numerator NPR § ___.2 (Definitions).

[35] Basel III Numerator NPR § ___.2 (Definitions).

The corresponding deduction approach provides for a deduction, in some circumstances, for investments in a capital instrument that is "common stock or represents the most subordinated claim in liquidation of the financial institution."[36] As before, this language is inconsistent with the "issued and outstanding common shares" standard and may capture non-common share instruments in some cases, including limited partnership interests. These inconsistencies could result in unlimited deductions of investments in limited partnership interests from regulatory capital, even though these interests represent the most subordinate claim in the capital structure of the financial institution. As discussed in detail, these inconsistencies could also potentially exacerbate the already substantial difficulties facing the largest banking organizations as part of any attempt to implement the proposed deductions for direct and indirect investments in financial institutions, as it will be difficult, if not impossible, for these banking organizations to measure with any precision the nature and scope of their direct and indirect holdings in the capital of financial institutions.

The Associations also seek clarification from the Agencies that a deduction would not be required with respect to certain types of indirect investments in financial institutions, *i.e.*, investments in unconsolidated financial institutions held through another unconsolidated financial institution in which a banking organization has invested. For example, a banking organization may have an investment in Unconsolidated Financial Institution A, which in turn has an investment in Unconsolidated Financial Institution B. In these types of situations, the Agencies should clarify that the banking organization would not be deemed to have an indirect investment in Financial Institution B for purposes of the proposed thresholds and capital deductions because its investment in Financial Institution A is already subject to the applicable thresholds and deductions.

### J. Investment Amount for Capital Deductions Related to Investments in the Capital of Unconsolidated Financial Institutions Should Recognize Effective Hedging Arrangements for Trading Book Exposures

Under the Basel III Numerator NPR, an "investment in the capital of an unconsolidated financial institution" includes a net long position in an instrument that is recognized as capital for regulatory capital purposes and would include direct, indirect and synthetic exposures to such instruments, excluding underwriting positions held by a banking organization for five business days or less. The NPR defines a "net long position" as the gross long position offset by short positions where either (i) the maturity of the short position matches the maturity of the long position (*i.e.*, the matching maturity criteria) or (ii) the

[36] Basel III Numerator NPR § ___.22(c)(2).

maturity of the short position has a residual maturity of at least one year (*i.e.*, the residual maturity criteria).[37]

The rationale for a net long exposure measurement is that short positions can effectively eliminate a banking organization's economic exposure, in which case there is no reason to require a capital deduction. However, the Associations are concerned that, while this measure of "investment" may be appropriate for longer term equity investments in the banking book, it is unsuitable for trading book exposures and would not "be equivalent to the banking organization's potential loss should the underlying capital instrument have a value of zero."[38]

Banking organizations engage in a wide range of capital instrument-related transactions to facilitate clients' trading and investment strategies. As market makers, banking organizations will take the other side of client-initiated transactions; for example, if a mutual fund wished to invest in (take a long position in) Financial Institution A stock, a market-making banking organization must be willing to take the offsetting short position in Financial Institution A stock, perhaps via an equity swap. The banking organization would then seek to hedge the risk of that short position with a long position, perhaps in the stock itself or with other financial instruments.

Market-making banking organizations hold many effectively hedged capital instruments on their balance sheets to accommodate client requests, often with no net market risk exposure to the issuer of the capital instrument. If a crisis event were to occur, a banking organization would have no market risk exposure to fully hedged capital instruments. Rather, the banking organization would be exposed to its hedge counterparty, typically a client, and the exposure is counterparty credit risk rather than market risk. In substance, this arrangement is similar to a margin loan where the banking organization has extended credit to its client to facilitate the client's trading and investment activities and the client bears the market risk.

### 1. Illustrating the Maturity Matching Criteria and Residual Maturity Criteria under the Basel III Numerator NPR

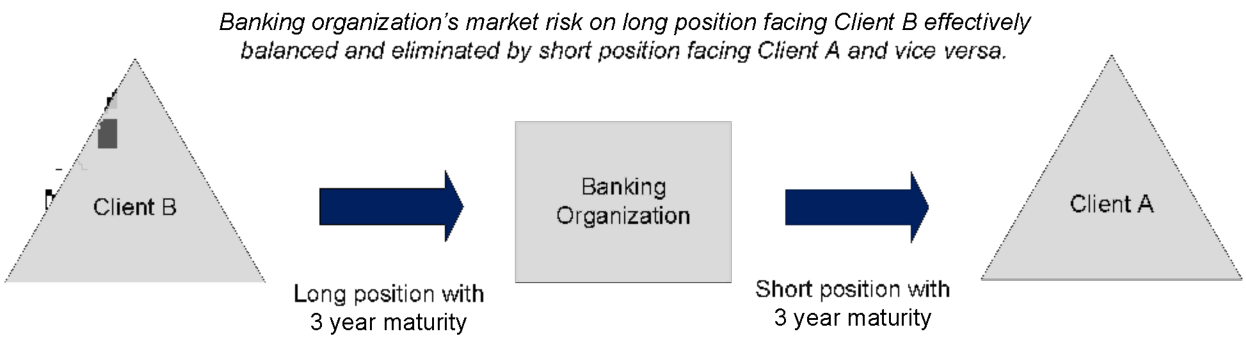
The maturity matching criteria in the Basel III Numerator NPR recognize that a banking organization can enter into offsetting positions with matching maturities that effectively eliminate market risk. For example, as depicted in **Diagram A-1** below, the banking organization's market risk on its short position with Client A is hedged by its long position with Client B and vice versa; the banking organization is protected against market

[37] Basel III Numerator NPR § ___.2 (Definitions).

[38] Basel III Numerator NPR at 52,821.

risk regardless of the performance of the underlying equity instrument. The Basel III Numerator NPR recognizes that, when a banking organization's balance sheet positions meet the matching maturity criteria, no regulatory capital deduction is necessary.

**<u>Diagram A-1</u>: Illustrative Transaction Meeting the Matching Maturity Criteria**




The residual maturity criteria apply to analogous circumstances in which a banking organization's market risk is effectively eliminated through hedging arrangements even though the offsetting positions do not have the same maturity. For example, a banking organization might have two positions related to the same underlying equity instrument, as depicted in **Diagram A-2** below: a short equity-linked swap position facing Client A with a three-year maturity and a balance sheet exposure to the underlying equity instrument, which is effectively a long position with perpetual maturity. The banking organization's market risk on its short position with Client A is hedged by holding the equity instrument on its balance sheet and vice versa; as in the above example, the banking organization is protected against market risk regardless of the performance of the underlying equity instrument.

**<u>Diagram A-2</u>: Illustrative Transaction Meeting the Residual Maturity Criteria**

### 2. Banking Organizations Engage in a Wide Range of Capital Instrument-Related Transactions to Facilitate Clients' Trading and Investment Strategies

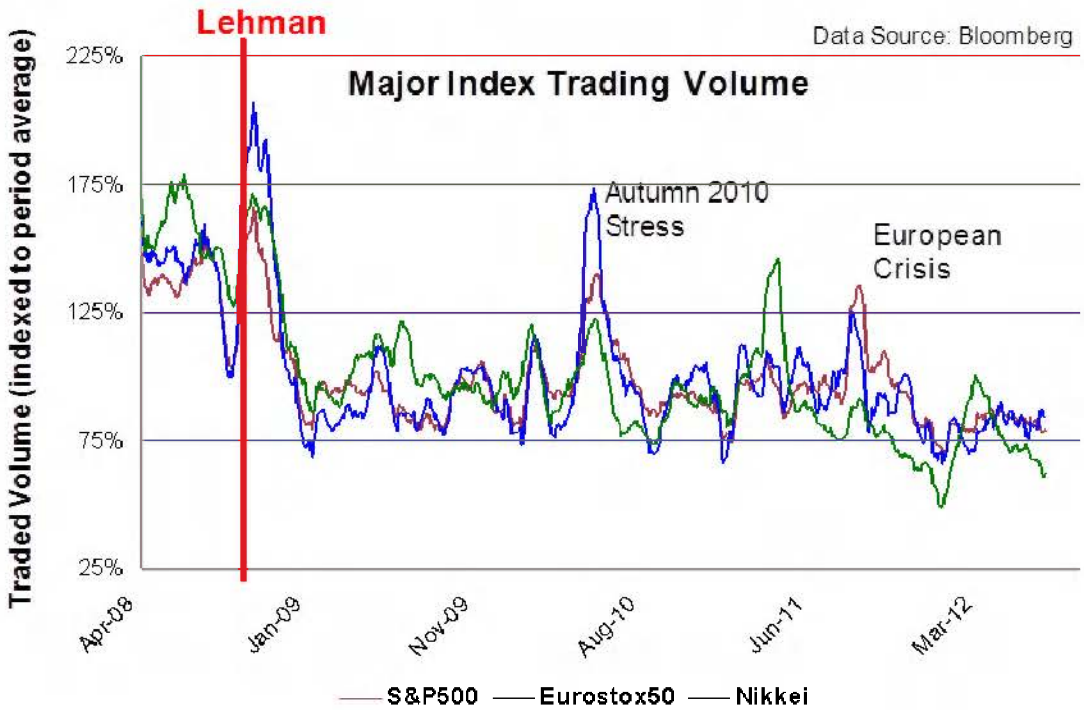
Banking organizations engage in a wide range of capital instrument-related transactions to facilitate clients' trading and investment strategies. However, as explained further below, even when effectively hedged, these exposures may not meet the matching maturity criteria or the residual maturity criteria under the Basel III Numerator NPR.

As one example, equity-linked swap transactions play a large role in the overall market for equities, and an overbroad capital deduction would have significant market effects. The typical counterparties for equity-linked swaps are asset managers and funds—not banking organizations—which make extensive use of these swaps to gain exposure to financial institutions' equity securities, accessing markets that may otherwise be inaccessible or difficult to replicate.

Requiring banking organizations to take a regulatory capital deduction for equities held as hedges against those equity-linked swaps would make many such transactions uneconomic for banking organizations, thereby restricting client access to equity exposures and causing disruptions to market activity. Since many asset managers primarily utilize equity-linked swaps to gain exposure to equities, the proposed capital deduction would materially weaken these instruments' liquidity, impacting asset managers' ability to invest and trade. From a risk perspective, these arrangements are comparable to other normal course banking activities, such as providing margin loans.

Moreover, equity markets have proven to be deep and liquid even during moments of extreme market stress, permitting banking organizations to close out positions related to client-facilitation transactions without difficulty. As demonstrated in **Chart A-1**, equity markets' liquidity was robust even in September 2008 following the bankruptcy filing of Lehman Brothers Holdings Inc. Banking organizations' role facilitating client and trading investment strategies is consistent with prudent risk management and the Agencies' policy goal of reducing systemic interconnectedness among major financial institutions.

**Chart A-1: Equity Markets' Liquidity, 2008-2012**




### 3. Trading Book Exposures Should Be Exempted from Proposed Deduction for Investments in the Capital of Unconsolidated Financial Institutions

The Associations support the rationale of the matching maturity criteria and the residual maturity criteria when applied to the banking book. However, as formulated in the Basel III Numerator NPR, neither set of criteria appropriately addresses a banking organization's exposures in the trading book, which include a banking organization's market-making positions.[39] While the trading book exposures may be fully hedged, effectively eliminating market risk, these positions may not involve offsetting positions of matching maturities or offsetting positions where the short position has a maturity of at least one year.

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[39] Trading book refers to covered positions under the Market Risk Final Rule. The Market Risk Final Rule defines covered positions "to include assets that are in the trading book and held with the intent to trade," more specifically, trading assets and trading liabilities that are trading positions, *i.e.*, held for the purpose of short-term resale, to lock in arbitrage profits, to benefit from actual or expected short-term price movements, or to hedge covered positions. In addition to commodities and foreign exchange positions, covered positions include certain debt positions, equity positions and securitization positions. Any position that is not in the trading book for this purpose is referred to as a "banking book" position.

The Associations believe that the matching maturity criteria and the residual maturity criteria, as formulated in the Basel III Numerator NPR, are conceptually inconsistent with the Agencies' Market Risk Final Rule, which governs positions held in the trading book and requires that these positions, and/or hedges to these positions, be short-term in nature. Trading book positions must also be able to be hedged in a liquid, two-way market; given that for many equity-linked financial instruments, the longer term markets are much less liquid than short-term markets, it is questionable whether many hedges to investments in financial institutions with residual maturities of greater than one year would even be eligible to be included in the trading book. As such, the Associations believe that a one-year maturity requirement would be inconsistent with supervisory safety and soundness expectations that the banking organization actively and dynamically manage its market risk exposures through approved trading and hedging strategies.

Accordingly, the Associations urge the Agencies to exempt trading book exposures from the proposed capital deduction regime for investments in the capital of unconsolidated financial institutions.

#### 4. If Capital Deductions Are Required for Trading Book Exposures, then Investment Amount of these Exposures Should be Calculated Consistent with the Market Risk Final Rule and with Reference to Effective Hedging Arrangements for Trading Book Exposures

The Associations do not believe the proposed deduction for investments in the capital of unconsolidated financial institutions should apply to trading book exposures. However, should the Agencies decide to apply the deduction to trading book exposures, the Associations believe that the exposure amount should be determined in a manner that is consistent with the market risk capital framework, and should take into account effective hedging arrangements for trading book positions. Neither the matching maturity criteria nor the residual maturity criteria, as proposed in the Basel III Numerator NPR, capture the unique risk profile and market characteristics of trading book activities. If calculated through alternative criteria appropriate for the trading book, however, the investment amount would better reflect a banking organization's actual economic exposure and would be more consistent with the market risk capital framework.

The Associations suggest three possible approaches for calculating trading book exposures:

- **Option 1:** Applying a delta-based measure of exposure, consistent with the Market Risk Final Rule[40] and reflective of the banking organization's actual market risk exposure;

- **Option 2:** Applying the index decomposition netting criteria in the Basel III Numerator NPR, which requires that a banking organization's internal control processes confirm that an "effective hedge" is in place; or

- **Option 3:** Allowing a banking organization to net exposures where contractual arrangements permit the banking organization to determine the close-out positions of offsetting exposures.

**Option 1: Trading Book Exposures Should Be Measured Through a "Delta" Calculation Consistent with the Market Risk Final Rule**

The Associations believe that the most logical approach to determining a banking organization's net long positions in the capital of unconsolidated financial institutions within the trading book would be to rely on a delta-based measure of exposure. In practice and, as required by the Market Risk Final Rule, banking organizations manage exposures as a function of delta, which measures the relationship of a change in the instrument's value with changes in an underlying factor (such as a stock price). For example, consider a deeply out-of-the-money one-day call option with a spot price of 100 and a strike price of 120. The probability of hitting the strike price in one day is low, which will typically result in a delta of close to zero. However, the delta will gradually increase as the expiration date is extended, which reflects the higher probability of the price moving to 120.

Deltas are additive and allow for a common measure of exposure across a variety of products, such that risk can be efficiently managed at a portfolio level. In practice, to determine its exposure to the capital of a single financial institution, a banking organization would net its long and short positions on a delta-adjusted basis, taking into account the variety of risk factors (*e.g.*, maturity) that impact its various positions.

Deltas represent a risk-sensitive measure of exposure that much more accurately reflects risk than the Agencies' proposed derivation of a net long position. Moreover, deltas are used to calculate market risk capital and represent a well-understood concept used to manage the risks of trading book exposures precisely because they take maturity into

[40] *See* Market Risk Final Rule at 53,073 ("For debt, equity, and securitization positions that are derivatives with nonlinear payoffs (for example, options, interest rate caps, tranched positions), a bank must risk-weight the market value of the effective notional amount of the underlying instrument or instruments multiplied by the derivative's delta (that is, the change of the derivative's value relative to changes in the price of the underlying instrument or instruments).").

consideration. Accordingly, the simplest and most accurate approach for calculating a banking organization's economic exposures for trading book positions would be to rely on delta calculations developed for market risk capital purposes. This approach would be consistent with the Agencies' market risk capital framework and would utilize banking organizations' existing risk model calculations.

**Option 2: Trading Book Exposures Should Be Eligible for Netting If They Meet the Netting Criteria Applicable to Index Exposures**

Alternatively, the Basel III Numerator NPR recognizes that banking organizations may have exposures to capital instruments, or offsetting hedges to capital instruments, through investments in indices. Short positions in an index can be used to hedge long cash or synthetic positions to determine the net investment exposure in the capital instrument of an unconsolidated financial institution. To determine the portion of an index that may be used as an eligible short, the Basel III Numerator NPR requires that (i) both positions are subject to the Market Risk Final Rule, (ii) both positions are fair-valued on the banking organization's balance sheet and (iii) the hedge is deemed effective by the banking organization's internal control processes assessed by the primary supervisor of the banking organization.[41]

As an alternative to the "delta" approach, the Associations would support this approach to determining the portion of the short index exposures that may be used to offset the long position, since it incorporates the key elements of measuring economic exposure. In particular, this calculation recognizes a practical test for measuring trading book exposures, which are necessarily short-term and are subject to enhanced capital requirements through the Market Risk Final Rule.

More generally, the Associations believe that the aforementioned treatment of short positions in indexes should be applied to all trading book exposures. There is no meaningful economic difference between an exposure acquired through an index as compared to a direct or synthetic exposure; in each instance, the banking organization has market risk (if unhedged) to the underlying position. The regulatory capital rules should be applied consistently to all economically equivalent exposures since the underlying policy goal of the Basel III Numerator NPR is to require deductions for actual economic exposures to the capital of unconsolidated financial institutions.

Accordingly, for trading book exposures, the net long position could be calculated as the gross long position in the exposure to the capital of the financial institution net of short positions in the same exposure where (i) both positions are subject to the Market Risk Final Rule, (ii) both positions are fair-valued on the banking organization's balance sheet and (iii)

[41] Basel III Numerator NPR § ___.2 (Definitions).

the hedge is deemed effective by the banking organization's internal control processes assessed by the primary supervisor of the banking organization.

**Option 3: Trading Book Exposures Should Be Eligible for Netting if the Banking Organization Can Determine the Final Price, such that the Final Price of the Short Position is the Same as the Sale Price of the Long Position, thus Eliminating Market Risk Associated with Termination or Unwind of the Short Position**

Should the Agencies decide not to adopt either of the two trading book exposure methodologies described above, they should, at a minimum, permit banking organizations to calculate their trading book exposures by netting positions where the banking organization can determine the final price, such that the final price of the short position can be the same as the sale price of the long position, thus eliminating market risk associated with termination or unwind of the short position.

For example, a banking organization may face a client on a swap in which the client establishes a long exposure to the capital instrument of another financial institution. Since the banking organization has a short position in the swap, it may choose to purchase the underlying equity instrument to hedge its exposure to the client. If the swap has a maturity of less than one year, holding the equity instrument on its balance sheet may require the banking organization to deduct 100 percent of the position, even though the banking institution's exposure to the financial entity is entered into to hedge its exposure to its client. Deductions related to such client-facing activities could be very significant for banking organizations that regularly enter into swaps or similar instruments with clients.

In the situation described above, a regulatory capital deduction is unwarranted because the banking organization's market risk on the underlying equity instrument is fully hedged; the banking organization's risk arises from its credit risk to its client. In fact, from a risk perspective, the equity swap transaction and dealer hedge described above replicate the economics of a secured financing transaction, such as a margin loan. Clients have legitimate reasons for choosing equity-linked swap arrangements as opposed to outright purchases of equity instruments through a margin loan, and it would be illogical to assign different regulatory capital treatments to the two categories of transactions, since the underlying risk is the same.

Further, contractual arrangements ensure that clients, not banking organizations, bear the market risk of equity positions when banking organizations hold equities on their balance sheets to hedge equity-linked swap positions. Clients are generally required to post significant initial margin to cover potential future falls in the value of the underlying equity instruments, as well as post daily variation margin to cover ongoing changes in the value of such instruments.

In addition, a banking organization will terminate their hedge (and thus its equity exposure) at the same time as the termination of the client equity-linked swap positions. The banking organization determines the final price of the swap and can thus eliminate the market risk associated with terminating the swap position. Equity markets have demonstrated strong and reliable liquidity, even in times of market stress, ensuring banking organizations are able to sell equities in response to client requests to terminate equity-linked swaps in an orderly and non-disruptive manner, providing even more protection beyond contractual protections and daily margining.

The Associations' proposed treatment of equity positions held as hedges against equity-linked swap positions is also consistent with clarifying guidance from the Basel Committee with respect to analogous transactions. Specifically, the Basel Committee's frequently asked questions ("**FAQs**") concerning the definition of capital state that, for positions in the trading book, if a banking organization has a contractual right/obligation to sell a long position at a specific point in time and the counterparty in the contract has an obligation to purchase the long position if the banking organization exercises its right to sell, this point in time may be treated as the maturity of the long position. In this situation, according to the Basel Committee's FAQs, the maturities of the long position and the short position are deemed to be matched even if the maturity of the short position is within one year.[42]

As in the situation described above, equities held as long-position hedges to short positions in equity-linked swaps are typically governed by contractual arrangements that permit the banking organization to sell the equities at the same point in time when closing out the equity-linked swap, and to recover any shortfall in value of the equities under the terms of the swap. Although a banking organization may not have a contractual right to sell the equity position to the client at a specified price, the banking organization has contractual certainty that the net amount it will receive from selling the stock in the market can match the final price on the swap contract. This will occur on dates specified in the swap agreement: either the maturity date of the swap or, as the majority of equity-linked swaps can be terminated early at the option of either side, on the date of such termination. Hence, as in the case of a long position where the banking organization has a contractual right to sell on a specific date, in the case of equity-linked swaps the banking organization has contractual certainty that it can close out its position with no market risk on dates as specified for each swap. Such positions are therefore identical from a risk perspective to the trading book positions described in the Basel III FAQs.

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[42] *See* Basel Committee, *Basel III Definition of Capital Frequently Asked Questions*, Paragraphs 78–89 (Investments in own shares, investments in the capital of banking financial and insurance entities and threshold deductions), Question 17 (Dec. 2011), *available at* http://www.bis.org/publ/bcbs211.pdf.

### K. Investments in Own Capital Instruments

The Basel III Numerator NPR would, consistent with International Basel III, require holdings in a banking organization's own capital instruments to be deducted from regulatory capital. In order to determine the amount of such holdings, a banking organization would be required to look through to the underlying positions of index securities to determine whether it was indirectly holding its own capital instruments. The Associations believe that the burden of the proposed look-through approach greatly outweighs the potential benefit, as it is highly unlikely that a banking organization would use purchases of index instruments as a means to conduct "covert" share repurchase activities. Furthermore, the overly restrictive limitations on the recognition of hedges for this purpose are similar to the restrictions that apply to holdings in unconsolidated financial institutions. The Associations request relief from the "look-through requirement" for index securities on the grounds that these are not "quiet buybacks," but rather incidental positions often held within banking organizations' trading books. Although International Basel III and the Basel III Numerator NPR permit a banking organization to use a conservative estimate in lieu of monitoring exact exposures (subject to supervisory approval), estimating the exposure would not tangibly ease the operational burden. Even using an estimate, a banking organization would still need to do a significant amount of analysis to determine, *e.g.*, the quanta of its exposure to its own capital instrument, especially when that capital instrument makes up an exceedingly small portion of the fund's overall assets. In light of these significant operational burdens, the Associations request general relief from the look-through requirement for exposures to index funds or, in the alternative, targeted relief from the look-through requirement if an index fund is not predominantly invested in financial institutions.

### L. Investments in Insurance Underwriting Subsidiaries

The Basel III Numerator NPR would require that a banking organization with an insurance underwriting subsidiary deduct from its consolidated capital ratios an amount equal to the minimum regulatory capital requirement established by the regulator of any insurance underwriting subsidiary of a BHC or SLHC. For U.S.-based insurance underwriting subsidiaries, this amount generally would be 200 percent of the subsidiary's authorized control level risk-based capital, as established by the appropriate state regulator of the insurance company.

The Associations respectfully submit that the proposed deduction for investments in insurance underwriting subsidiaries reflects a misunderstanding of the insurance risk-based capital framework. Among other risks, the insurance risk-based capital framework specifically accounts for asset-specific risks that are also included in the risk-based capital rules for banking organizations. The risk-based capital framework for life insurers measures five specific categories of risk:

C0 – Asset Risk – Affiliates;

C1 – Asset Risk – Other;

C2 – Insurance Risk;

C3 – Interest Rate Risk; Health Credit Risk; Market Risk; and

C4 – Business Risk.

For property and casualty insurers, the risk-based capital framework measures six specific categories of risk:

R0 – Asset Risk – Affiliates;

R1 – Asset Risk – Fixed Income Investments;

R2 – Asset Risk – Equity Investments;

R3 – Asset Risk – Credit;

R4 – Underwriting Risk – Reserves; and

R5 – Underwriting Risk – Net Written Premium.

For life insurers, asset-related risks are encompassed in the C0, C1 and C3 categories, which measure risks arising from the asset side of the balance sheets of the insurer and its affiliates, as well as interest rate and market risks highly correlated with the asset composition and quality of the insurer's balance sheet. For property and casualty insurers, asset-related risks are encompassed in the R0, R1, R2 and R3 categories, which also measure risks arising from the asset side of the balance sheet of the insurer and its affiliates. In light of these similarities, it would be overly burdensome to require a banking organization to deduct capital held by its insurance underwriting subsidiary to cover these risks when the capital measures the same types of risks as the general risk-based capital rules.

To the extent the Federal Reserve Board deems it necessary for a banking organization to deduct any capital held by its insurance underwriting subsidiaries, these deductions should encompass only the categories of insurance risk-based capital that do not measure asset-specific risks, such as the C2 and C4 categories for life insurers and the R4 and R5 categories for property and casualty insurers. It is puzzling that the Federal Reserve Board would require a consolidated enterprise to deduct capital held by a subsidiary to the extent that the capital framework applicable to the subsidiary measures comparable risks as the framework applicable on a consolidated basis. The contemplated deduction of capital held by insurance underwriting subsidiaries inappropriately negatively impacts the business of insurance, and does so by penalizing a capital framework that measures risk in a manner generally similar to the general risk-based capital rules.

### M. Additional Tier 1 Capital—Proposed Eligibility Criteria

The proposed criteria for Additional Tier 1 capital would serve to exclude almost all instruments issued by U.S. banking organizations, with the exception of noncumulative perpetual preferred stock. The Associations have several reservations regarding the proposed criteria for Additional Tier 1.

The Basel III Numerator NPR provides that, in order for an instrument to qualify as Additional Tier 1, a banking organization must have full discretion to cancel dividends or other capital distributions on the instrument without triggering an event of default, a requirement to make a payment-in-kind, or an imposition of other restrictions on the banking organization except in relation to any capital distributions to holders of common stock. The Associations have several concerns with this provision.

First, the Associations believe it is the Agencies' intent for noncumulative perpetual preferred stock to qualify as Additional Tier 1 capital. However, the dividend/distribution limitations included in the proposal present concerns for noncumulative perpetual preferred stock. Specifically, noncumulative perpetual preferred stock typically has a "dividend stopper" or similar arrangements that require the banking organization to stop making dividend payments on other Tier 1 instruments if dividends are not paid on the preferred stock. In fact, some noncumulative perpetual preferred stock may have arrangements that require a banking organization to cease making dividend payments on all other preferred stock if it stops dividend payments on particular noncumulative perpetual preferred stock. These arrangements could potentially deviate from criterion (vii). The Basel Committee has addressed this issue, stating explicitly that the Additional Tier 1 criteria do not prohibit dividend stopper arrangements with respect to other Additional Tier 1 instruments.[43] The Agencies should interpret criterion (vii) for Additional Tier 1 in a manner consistent with the Basel Committee's interpretation, such that dividend stopper arrangements that stop dividend payments on Tier 1 instruments will not preclude noncumulative perpetual preferred or additional parity preferred stock from qualifying as Additional Tier 1.

Second, the Agencies propose to add a requirement whereby an instrument would qualify as Additional Tier 1 capital only if the payment of a penny dividend on common stock did not preclude a banking organization from canceling or making marginal dividend payments on Additional Tier 1 capital instruments. The Associations would not be supportive

[43] *See* Basel Committee, *Basel III Definition of Capital - Frequently Asked Questions*, Paragraphs 54–56 (Criteria for Additional Tier 1 Capital), Question 3 (Dec. 2011), *available at* http://www.bis.org/publ/bcbs211.pdf ("Dividend stopper arrangements that stop dividend payments on common shares are not prohibited by the Basel III rules text. Furthermore, dividend stopper arrangements that stop dividend payments on other Additional Tier 1 instruments are not prohibited.").

of such a requirement as it would significantly increase the cost of issuing Additional Tier 1 instruments. Developments during and subsequent to the recent financial crisis have made clear to bank investors that the risk that common dividends may be reduced or eliminated is higher than was the case historically. The Associations believe the adverse impact this requirement would have on the preferred markets would likely outweigh the potential benefit to equity markets of preserving penny dividends while stopping payment on preferred dividends. Investors in preferred stock view the dividend stopper as a key feature that provides some protection against the elimination of their preferred dividends. Unlike the common stock investor, the benefits of a reduced dividend will not accrue to a preferred stock investor in a recovery scenario, as preferred holders' dividends are noncumulative and therefore any missed dividend is permanently lost to them. Preferred stock investors may be of the view that if a banking organization has limited need to access the preferred markets, it would be incentivized to make decisions to maximize returns to the common stock investors at the expense of the preferred stock investors. As a result, the Associations believe that preferred stock investors would demand significantly higher returns on their investments to compensate for the increased probability of non-payment.

Notwithstanding the foregoing, the Associations recognize that certain banking organizations may find it beneficial to have this option, and may choose to offer securities that contain the language suggested by the Agencies, provided such instruments would qualify as Additional Tier 1 capital. While the Associations would support the inclusion in Additional Tier 1 capital of instruments with such an *option*, the Associations do not believe it would be prudent to make this a requirement.

However, if this criterion were added as a requirement, the Associations strongly believe that it should be added only prospectively and should not apply to existing instruments. Grandfathering existing instruments would at least help to avoid needless disruptions to banking organizations' operations that could otherwise result, as certain instruments already issued will have dividend-related provisions that would make them ineligible for Additional Tier 1 because of this criterion.

In addition, the requirement that a banking organization receive prior approval from the agency to exercise a call option is redundant: Under the Basel III Numerator NPR, all redemptions or repurchases of Additional Tier 1 instruments are subject to prior regulatory approval. This redundancy is also an issue with respect to the Tier 2 criteria. The Associations suggest that both sets of criteria be modified to remove this potential redundancy.

Under the Basel III Numerator NPR, an instrument classified as a liability under GAAP would not qualify as Additional Tier 1, which would have the practical effect of excluding contingent capital instruments from Additional Tier 1. Contingent capital instruments have gained support in recent years as a potential alternative to common equity as Tier 1-eligible instruments. These types of instruments are dated bonds with principal and scheduled coupon payments that may be converted into equity or written down upon the occurrence of a trigger event (such as regulatory capital levels dipping below predetermined levels), enabling a fresh injection of capital into a distressed banking organization. The Basel III Numerator NPR's requirement that Additional Tier 1 be classified as equity under GAAP appears to close the door on any possible recognition of such debt-hosted contingent capital instruments in Additional Tier 1. This does not appear to be a distinction that is necessary to equip an existing capital instrument with the loss-bearing characteristics of Additional Tier 1. The Associations note that European supervisory authorities have not foreclosed the option of including contingent convertibles and similar instruments in Additional Tier 1 capital. The Associations also note that tax laws in the U.S. generally require a tax-deductible Additional Tier 1 instrument to be a debt instrument, which is not necessarily the case in other jurisdictions, creating a further competitive disadvantage for the U.S. banking system. The Associations note that the Agencies have discussed holding company debt as being essentially "capital" in a liquidation scenario; this begs the question why instruments that serve as actual capital during liquidation should not count as regulatory capital.

Contingent capital instruments, which would not likely be classified as equity under GAAP, have the potential to provide for additional loss absorption capacity. The Associations urge the Agencies to reconsider the requirement that instruments classified as liabilities under GAAP are ineligible for Additional Tier 1 treatment or to provide specifically that contingent capital instruments will remain eligible for treatment as Additional Tier 1 notwithstanding this requirement.

### N. Tier 2 Capital—Proposed Eligibility Criteria

Consistent with International Basel III, the Basel III Numerator NPR would require an instrument to meet certain enumerated criteria to be eligible as Tier 2 capital. The Associations note that certain of the proposed criteria in the Basel III Numerator NPR may make it difficult for trust preferred securities ("**TruPS**") to qualify as Tier 2 capital, despite the Agencies' stated intention that these instruments "could qualify for inclusion in tier 2 capital under the proposed eligibility criteria for tier 2 capital instruments."[44]

The Agencies propose that in order for an instrument to be eligible as Tier 2 capital, it could be called by the banking organization only after a minimum of five years following issuance, except that the terms of the instrument could allow it to be called sooner upon the occurrence of an event that would preclude the instrument from being included in Tier 2 capital, or a tax event. Redemption provisions are a common feature of TruPS that protect the

[44] Basel III Numerator NPR at 52,814.

tax-advantaged characteristics of these securities. The Associations have three concerns about the proposed Tier 2 criteria and recommend revisions to the criteria to ensure that TruPS meeting the substantive Tier 2 requirements qualify as Tier 2 capital.

First, the proposed Tier 2 eligibility criteria do not recognize an exception for a redemption within five years of issuance in the case of an investment company event, even though they recognize exceptions for regulatory and tax events. Investment company event call rights are analogous to regulatory and tax event call rights; in each case, they ensure that the issued capital instrument maintains its legal, regulatory and/or tax profile after issuance without creating incentives for early redemption. The Associations do not believe the Agencies intend to exclude TruPS that contain such market standard provisions from Tier 2 capital, and request that the Agencies clarify in the final rule that an instrument is eligible for inclusion in Tier 2 capital if its terms recognize an early call right for an investment company event.

Second, the proposed Tier 2 criteria would exclude TruPS with limited guarantees under which the issuing banking organization guarantees interest and maturity payments on the trust preferred stock. Such provisions are intended to ensure that payments made by the banking organization to the trust are used by the trust to pay its obligations on the TruPS, not to enhance the seniority of the TruPS. Again, these provisions are common to many TruPS and should not disqualify such instruments from qualifying as Tier 2 capital.

Third, the Associations request clarification that provisions which permit acceleration of payments after the end of permitted interest deferral periods will not preclude an instrument from qualifying as Tier 2 capital. The existing regulatory capital rules permit TruPS to include provisions providing for an event of default and the acceleration of principal and accrued interest upon nonpayment of interest for 20 or more consecutive quarters.[45] In reliance on these rules, many banking organizations issued TruPS with 20-quarter deferred interest acceleration provisions, and such provisions are common to many outstanding TruPS instruments. These provisions are also consistent with the Basel III Numerator NPR's requirement for Tier 2 capital instruments to have a minimum original maturity of at least five years,[46] since 20 quarters of deferred interest will occur, at the earliest, five years after issuance of an instrument.

The Associations support the proposed inclusion in Tier 2 capital of allowances for loan and lease losses ("**ALLL**") not exceeding 1.25 percent of a banking organization's total standardized risk-weighted assets. The proposed inclusion, consistent with International

[45] *See* 12 C.F.R. Part 225, App. A § II.A.c.iv.(2).

[46] Basel III Numerator NPR § __.20(d)(iv).

Basel III, affords appropriate recognition to the fact that ALLL are freely available to meet losses that subsequently materialize and therefore qualify for inclusion within Tier 2. However, under the Basel III Numerator NPR, when calculating its advanced approaches total capital ratio, rather than including in Tier 2 capital the amount of ALLL described above, an advanced approaches banking organization may only include the excess of eligible credit reserves over its total expected credit losses to the extent that such amount does not exceed 0.6 percent of its total credit risk-weighted assets. While this treatment is consistent with the Agencies' existing advanced approaches rules and the Basel capital framework, it could result in a lesser amount being included in Tier 2 capital than under the approach applicable to non-advanced approaches banking organizations. The Associations therefore encourage the Agencies to consider whether this treatment should be revised to ensure comparable treatment across all U.S. banking organizations. The capital treatment of ALLL is also a particular example of an instance where, as noted above, reevaluation will be warranted on an ongoing basis in light of changing accounting standards.

## III. Capital Buffers

### A. Capital Conservation Buffer

The Basel III Numerator NPR would establish a capital conservation buffer that is intended to incentivize banking organizations to maintain their CET1, Tier 1, and total capital ratios above the required minimums. Specifically, banking organizations would need to hold capital conservation buffers in an amount greater than 2.5 percent of total risk-weighted assets (for advanced approaches institutions, this amount could be increased by any applicable countercyclical capital buffer amount) in order to avoid being subject to limitations on dividend payments, capital distributions and discretionary bonus payments to executive officers.

The Associations believe that, once implemented, the capital conservation buffer will function as a *de facto* minimum capital requirement. As the Agencies are well aware, market and supervisory expectations will force banking organizations to hold capital in excess of this *de facto* minimum, essentially leading to additional "buffers" being maintained in excess of the required "buffers." [47]

The Associations are particularly concerned that the limitations on dividend payments, capital distributions and executive compensation contemplated by the Basel III Numerator NPR may have a deleterious effect on the U.S. banking industry, particularly for those institutions whose capital ratios are at or below 0.625 percent of the buffer. At or below

[47] For example, as discussed above, if the AOCI filter were removed, banking organizations would have to maintain higher capital buffers in anticipation of the volatility caused by unrealized gains and losses.

0.625 percent, the maximum payout ratio as a percentage of eligible retained income falls to zero, meaning that the banking organization would not even be able to pay penny dividends on common stock, effectively excluding certain institutional investors who cannot hold stock that does not pay dividends. Even though a banking organization may be above the technical minimum capital requirements, its inability to pay any dividend on common stock may make it more difficult to attract additional equity investors. For these reasons, the Associations strongly believe that a banking organization should be permitted to pay a penny dividend on its common stock notwithstanding the limitations imposed by the capital conservation buffer.

The Associations would also like to emphasize the special burden that this rule would have on community banks and on banking organizations potentially subject to a quantitative surcharge imposed by the Federal Reserve Board. Given their more limited access to capital markets, many community banks could face significant difficulties in meeting this requirement in addition to the new minimum capital requirements by calendar year 2013, as discussed above.[48]

Moreover, under the Agencies' proposals, certain U.S. banking organizations could become subject to a capital conservation buffer, a quantitative surcharge based on the Basel Committee's G-SIB framework and, potentially, a countercyclical buffer, all at the same time. This would impose capital requirements far beyond what is required for a safe and prudent banking system.

The Associations are also concerned about how the capital conservation buffer would function in practice. The first concern stems from the definition of "eligible retained income." Eligible retained income is defined as a banking organization's net income for the four calendar quarters preceding the current quarter, as reported in the banking organization's quarterly regulatory reports, net of any capital distributions, certain discretionary bonus payments and associated tax effects not already reflected in net income. This definition, however, fails to account for items included in net income, such as goodwill impairment and other non-capital charges, which are captured in the definition of "net income" for regulatory reporting purposes but which do not affect capital (the very measure this provision is attempting to conserve). The definition also fails to account for charges to items that are excluded, wholly or partly, from capital (such as a write-down on an investment that is deducted from capital under the rules). As a result, a banking organization could be forced to incur severe reputational and market impacts from a scenario that has little or no economic impact on the health of the firm, *e.g.*, a decrease in regulatory capital below the capital conservation buffer coupled with an instance of negative earnings where the latter was caused by a significant impairment of intangible assets (a non-capital charge which would not have

[48] The rule would also impose a special burden on mutual organizations, whose only meaningful mechanism for raising capital is through retained earnings.

been complicit in the breach in capital levels). In light of the potential materiality of non-capital charges, such as intangibles impairment, and the effect they may have on the ability to make payouts within the capital conservation buffer, including preferred dividend payments, the Associations believe there should be a mirroring between the income that contributes to capital and the income that determines a banking organization's ability to make capital distributions when within the buffer. The purpose of limiting capital distributions when ratios fall within the buffer is to ensure that banking organizations are conserving a portion of their income, and using an income calculation that includes potentially material items that do not impact capital would fail to recognize the full level of capital retention. The Associations therefore recommend that "eligible retained income" be redefined to remove non-capital charges that do not impact regulatory capital or that affect capital only partially and only to the extent of such effect.

Banks that have made an S Corporation tax election would also be subject to a significant disadvantage compared to their C Corporation peers under the proposed capital conservation buffer provisions. Under the tax rules, a shareholder of an S Corporation bank is subject to tax on their allocable share of the bank's profits regardless of whether such profits are distributed to the shareholders. Thus, if an S Corporation bank is profitable and meets its minimum capital requirements—but not the full capital conservation buffer—its shareholders will still be subject to tax on the S Corporation bank's profits at the shareholders' individual tax rates *without* a cash distribution from the S Corporation. In contrast, shareholders of C Corporation banks are not subject to tax unless there is an actual dividend distribution.

## IV. Leverage Ratios

### A. Supplementary Leverage Ratio

In addition to requiring their ongoing compliance with the existing leverage ratio, the Basel III Numerator NPR would require (only) advanced approaches banking organizations to satisfy a "supplementary leverage ratio" of Tier 1 capital to total leverage exposure of at least 3 percent—a concept introduced in International Basel III. The denominator of this new measure of total leverage exposure is designed to capture off-balance sheet exposures not included in the existing leverage ratio. The Basel III Numerator NPR itself does not expressly state the regulatory concern the supplementary leverage ratio is designed to address, but presumably the Agencies expect that such a broad-brush measure of total exposure will help to maintain liquidity with respect to, and constrain the build-up of, what they deem to be excessive off-balance sheet leverage among large banking organizations. For the reasons discussed below, the supplementary leverage ratio is unnecessary in light of the existing U.S. Tier 1 leverage ratio and too blunt a tool to effectively constrain perceived excessive leverage. Moreover, the supplementary leverage ratio could be detrimental to the availability of credit in the United States, which still has not fully recovered from the recent contraction in credit availability.

Furthermore, the supplementary leverage ratio is untested and not thoroughly developed, which makes it far too premature to impose upon U.S. banking organizations. The Associations believe that the Agencies should defer applying the supplementary leverage ratio as a requirement until they have had an opportunity to consider whether it is likely to result in regulatory arbitrage and international competitive inequality as a result of differences in national accounting frameworks and standards. Particularly given the fact that U.S. institutions are already (and have long been) subject to a leverage ratio requirement, the Associations believe it would be premature to impose a new leverage ratio requirement without fully understanding the magnitude of difference in impact between the existing leverage ratio and the supplementary leverage ratio.

While the Basel III Numerator NPR would make the supplementary leverage ratio a formal requirement for advanced approaches banking organizations beginning in 2018, International Basel III is more cautious, introducing the leverage ratio as an element of the supervisory review, but declining to impose it as a formal Pillar 1 requirement before the Basel Committee has had an opportunity to engage in that supervisory review. Instead, the Basel Committee notes that it will make "final adjustments to the definition and calibration of the leverage ratio" in 2017, "with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on appropriate review and calibration." The Associations believe that it would be more appropriate for the Agencies to engage in such a review and calibration of the supplementary leverage ratio before imposing it as a formal requirement on advanced approaches banking organizations. Such a review is implicit in the fact that advanced approaches banking organizations would be required to calculate and report their supplementary leverage ratios as of January 1, 2015. The Associations merely suggest that the Agencies should reserve to themselves the opportunity to substantively engage in such a review before formalizing the supplementary leverage ratio as a new capital requirement and an additional element of the prompt corrective action framework.

If, despite the foregoing, the Agencies decide to include a supplementary leverage ratio requirement in any final rules, the Associations note that the Basel III Numerator NPR provides that the denominator of the supplementary leverage ratio would include 10 percent of the notional amount of unconditionally cancellable commitments made by a banking organization. To the extent the denominator of the supplementary leverage ratio is designed to capture the total leverage exposure of advanced approaches banking organizations, the inclusion of unconditionally cancellable commitments in that measure is misguided. By definition, unconditionally cancellable commitments can be extinguished at any time in the sole discretion of an issuing institution; therefore, the inclusion of even 10 percent of such commitments in the measure of total exposure fails to accurately reflect such institutions' actual leverage exposure. The Associations understand that the proposal to include 10 percent of the notional amount of unconditionally cancellable commitments in the denominator of the supplementary leverage ratio mirrors the current calibration of the supplementary leverage ratio in International Basel III. However, the Basel Committee expressly notes that it will conduct further review to determine an appropriate approach to unconditionally cancellable commitments. The Associations urge the Agencies to do likewise and, at a minimum, to remove this component of the supplementary leverage ratio's denominator.

Finally, if the supplementary leverage ratio were included in any final rules, the potential inclusion of the notional value of off-balance sheet trade finance instruments in the denominator of the supplementary leverage ratio would increase the cost of providing these important, real economy-financing instruments to importers, exporters and other market participants. If included in the denominator of the supplementary leverage ratio, trade-related off-balance sheet instruments, including trade-related contingencies and transaction-related contingencies, could be reduced or cancelled, leading to substantially reduced trade flows and inhibiting growth in international trade.

The Associations submit that trade finance instruments are underpinned by the movement of goods and services and thus do not pose risks that the supplementary leverage ratio is intended to address. At a minimum, instead of including the full value of such instruments in any supplemental leverage ratio denominator, the Agencies should consider applying conversion factors consistent with International Basel II. Under this approach, trade finance instruments would be included at 20 percent of notional value for trade-related contingent items that arise from the movement of goods with an original maturity of one year or less and 50 percent of notional value for transaction-related contingent items, including performance bonds, bid bonds, warranties and performance standby letters of credit. This approach takes into account the nature of the instruments (*i.e.*, short-term, self-liquidating and low-risk) to ensure prices do not increase relative to capital allocation. As a matter of real economic impact, such an approach should help to avoid any decrease in U.S. exports or in the global competitiveness of the U.S. banking sector.

### B. Minimum Tier 1 Leverage Ratio

Unlike nearly all other jurisdictions, the United States has long used a non-risk-based leverage ratio as a backstop to risk-based capital ratios to set base capital requirements. U.S. banking organizations generally must maintain a minimum ratio of Tier 1 capital to average consolidated assets of at least 3 or 4 percent, while bank subsidiaries of financial holding companies must maintain a leverage ratio of at least 5 percent to be deemed "well-capitalized." Section 171 of the Dodd-Frank Act gives the Agencies the ability—but does not require them—to set higher leverage ratio requirements than those in effect during the crisis. The Basel III Numerator NPR would apply a minimum 4 percent leverage ratio requirement across the board to all banking organizations, thus removing an exception that currently allows strong depository institutions (those rated composite "1" under the CAMELS system and not experiencing or anticipating significant growth) to maintain a leverage ratio of 3 percent or greater while remaining adequately capitalized.

The Associations submit that the removal of the exception for strong depository institutions is unwarranted, especially given the cumulative effect of all of the capital requirements. Raising the minimum requirements on the strongest banking organizations may lead to further deleveraging by the very banking organizations most equipped to extend credit in a safe and sound manner.

Furthermore, even if reducing leverage exposure would have the effect of lessening the probability of a downturn by limiting exposure to positions that may need to be unwound during a crisis, the fact remains that once a downturn occurs, a restrictive leverage measure, in combination with stringent risk-based capital requirements, would unnecessarily constrain U.S. banking organizations' ability to extend credit, thus compounding the decline and resulting in slower economic growth. Rather than reducing the ability and incentive of strong institutions to lend in troubled economic times, the Agencies should rely on the sensitivity of the Agencies' risk-based capital ratios to ensure an adequate ratio of capital to exposures. Given that the totality of the Agencies' proposals will significantly increase capital pressure on banking organizations, the Agencies' discretionary imposition of a more restrictive leverage ratio on the strongest institutions seems imprudent, particularly in a time of fragile economic recovery. It will encourage affected banking organizations to cut back on lending at precisely the time the credit markets need relief and will negatively impact affected banking organizations' earnings and profitability, making it more difficult for them to raise capital at precisely the time they most need to raise capital to comply with stringent risk-based capital requirements. It may require a reassessment of the viability of areas of business that require leverage, possibly resulting in the unwarranted disposal of business units that pose little risk but have an outsized impact on a bank's leverage.

## V. Phase-out of Non-qualifying Instruments Including Trust Preferred Securities

The Basel III Numerator NPR takes a more conservative approach than is required by either International Basel III or the Dodd-Frank Act to the phase-out of non-qualifying capital instruments such as cumulative perpetual preferred stock and TruPS. In view of the difficulties that all banking organizations can expect to encounter in raising capital to comply with the myriad new and more stringent capital requirements proposed by the Basel III Numerator NPR, the Associations strongly urge the Agencies to (i) grandfather capital instruments issued before May 19, 2010 by depository institution holding companies with total consolidated assets of less than $15 billion as of December 31, 2009, as expressly permitted by the Dodd-Frank Act; and (ii) revise aspects of the Basel III Numerator NPR relating to the phase-out of non-qualifying capital instruments to align with the more gradual phase-out under International Basel III, to the extent permitted by the Collins Amendment.

### A. Depository Institution Holding Companies With Less Than $15 Billion in Total Consolidated Assets

The Basel III Numerator NPR takes a more conservative approach to TruPS and other non-qualifying capital instruments than the Dodd-Frank Act requires of depository institution holding companies with less than $15 billion in total consolidated assets and of depository institutions. In the Collins Amendment, Congress explicitly grandfathered the Tier 1 capital status of debt or equity instruments (such as TruPS) issued before May 19, 2010 by depository institution holding companies with less than $15 billion in total consolidated assets as of December 31, 2009. Although these institutions understood that no new TruPS instruments could be issued, grandfathering allowed small institutions to replace TruPS as they matured, resulting in an orderly replacement process. Since enactment of the Dodd-Frank Act, smaller banking organizations have relied on such instruments being grandfathered, and it would be unfair to subject such smaller institutions to additional, unexpected capital planning hurdles in an environment where the ability to raise additional capital is ever more constrained by competing issuances by other institutions that may need to access the capital markets to meet the more aggressive phase-out schedule for them than required by the Dodd-Frank Act.

### B. Depository Institution Holding Companies With $15 Billion or More in Total Consolidated Assets

The Basel III Numerator NPR would ratably phase out TruPS and other non-qualifying capital instruments issued by depository institution holding companies with total consolidated assets of $15 billion or more over a three-year period beginning in 2013, with full phase-out occurring on January 1, 2016. In contrast, International Basel III suggests ratably phasing out such instruments over a 10-year horizon beginning in 2013, with full phase-out occurring on January 1, 2022. The Associations understand that the Collins Amendment requires the phase-out of such instruments over a three-year period, but it does not require that they be phased out so aggressively in 25 percent increments, as opposed to the 10 percent increments suggested by International Basel III. Whereas a non-U.S. institution with assets of $15 billion or more that is subject to the International Basel III phase-out timeline would be allowed to include 90 percent of its TruPS in Tier 1 in 2013, a similar U.S. BHC or SLHC would be allowed to include only 75 percent. In year two, the non-U.S. institution would be allowed to include 80 percent, while the U.S. institution could include only 50 percent, and so on. In order to reduce the resulting competitive disadvantage to which U.S. institutions will be subjected and to give U.S. institutions additional flexibility to phase out non-qualifying capital instruments in an orderly and less punitive fashion, the Associations urge the Agencies to revise the phase-out of non-qualifying capital instruments issued by such institutions to reflect a phase-out in 10 percent increments in each of 2013 (*i.e.*, 90 percent includable in Tier 1), 2014 (80 percent includable in Tier 1) and 2015 (70 percent includable in Tier 1), with full phase-out occurring in 2016, in full compliance with the Dodd-Frank Act.

# ANNEX B

## Standardized Approach NPR: Comments and Recommendations

The Standardized Approach NPR proposes fundamental changes to the general risk-based capital requirements for determining risk-weighted assets in the denominator of risk-based capital ratios. The proposed requirements would apply to all U.S. banking organizations.

While supportive of creating a more sensitive risk-based capital framework, the Associations have strong overall reservations about the Standardized Approach NPR. Unlike prior risk-based capital proposals issued by the Agencies and based on the international Basel capital framework, the Standardized Approach NPR deviates significantly from the standardized approach agreed to by the Basel Committee in International Basel II. In particular, the use of a new and entirely different set of risk weights for residential mortgages is a complete deviation from the standardized approach under International Basel II. That substantial deviation is not required by the Dodd-Frank Act or any other U.S. law: It is instead an entirely discretionary set of changes proposed by the Agencies. Because the proposed changes are fundamentally different from the international Basel capital framework, which has been vetted through years of negotiation and implementation in other countries, the Agencies should be required to justify these changes, including by providing quantitative evidence of the appropriateness of proposed risk weights.

The Associations therefore recommend that the Agencies to take the following actions:

- Withdraw the Standardized Approach NPR to address its many problems and any re-proposal should be simplified and easier to follow and implement;

- Conduct an empirical study of the changes proposed to the current risk weight framework in the Standardized Approach NPR, focusing in particular on the necessity of changing residential mortgage risk weights in light of other pending proposals to tighten mortgage underwriting standards;

- Provide for the following in any re-proposal of the Standardized Approach NPR:

    - Reduce the risk weight mismatch among asset classes;

    - Recognize that performing loans are less risky than nonperforming loans; and

    - Re-calibrate the maximum risk weight so that it does not exceed the value of the asset.

This section of the letter sets forth in detail the Associations' concerns regarding the Standardized Approach NPR and makes recommendations regarding how such issues should be addressed in any re-proposed rule. In addition to residential mortgage aspects of the Standardized Approach NPR, this section of the letter also addresses the proposed capital treatment of commercial real estate ("**CRE**"), retail portfolios, exposures to securities firms, past due exposures, over-the-counter ("**OTC**") derivatives, cleared transactions, collateralized transactions, repurchase agreements and securities lending transactions, securitization and resecuritization exposures and equity exposures.

## I. Withdraw the Standardized Approach NPR

The Associations strongly believe that the Standardized Approach NPR should be withdrawn because the Agencies have not presented adequate empirical evidence demonstrating that the proposed changes to risk weights are correlated with actual differences in risk. A withdrawal of the Standardized Approach NPR is further supported by (i) the substantial regulatory and compliance burden the Standardized Approach NPR would place on *all* U.S. banking organizations; (ii) the fact that the Basel III Numerator NPR would independently and substantially strengthen minimum capital requirements for all banking organizations through significantly increased capital ratios and significantly more stringent definitions of qualifying capital, thus making the proposed changes in the Standardized Approach NPR far less necessary; and (iii) the fact that the proposed changes are not necessary for the United States to comply with the Basel capital accords (which are intended only for "internationally active" banks) and, indeed, constitute significant deviation from those standards in many instances, *e.g.*, the proposed changes in risk weights for residential mortgages.

### A. Substantially Increased Regulatory and Compliance Burden on All U.S. Banking Organizations

The Standardized Approach NPR imposes substantial burdens on all U.S. banking organizations because it requires them to significantly change the manner in which they collect and report information to calculate risk-weighted assets. For instance, as the Standardized Approach NPR expressly recognizes, many banking organizations would be "required to change their internal reporting process," provide "additional personnel training and expenses related to new systems (or modification of existing systems)," and "obtain additional information . . . in order to determine the applicable risk weights."[1] Such banking organizations must obtain, maintain and report new information about underwriting features and loan-to-value ("**LTV**") ratios of residential mortgage exposures, including home equity loans; obtain OECD CRCs for sovereign exposures; and, in the case of some banking

[1] Standardized Approach NPR at 52,933.

organizations, obtain sufficient information about underlying exposures to satisfy due diligence requirements and apply the Simplified Supervisory Formula Approach ("**SSFA**").[2] For instance, the Associations are not aware of any organization that reports all data required for the SSFA, including delinquency rates. And in many cases, information regarding mortgage underwriting characteristics also will not be available because the proposed rules were not in effect when banking organizations originated such mortgages years ago.

Given the substantial regulatory burden of the proposed new rules as they apply to mortgages, the Associations strongly urge the Agencies to grandfather the existing risk weights of mortgages under the current general risk-based capital requirements with respect to mortgages originated before the effective date of any final regulation. Such grandfathering of legacy mortgage exposures would alleviate the operational burdens and data constraints on banking organizations of retroactively applying the new rules to residential mortgage exposures and residential MBS—a problem that would be especially acute because the data required to be collected will in many cases not exist. Grandfathering would also make the transition to the new rules much more manageable and reasonable as existing loans are replaced by new ones—a process that will occur over a reasonable period given that the relatively short average duration of mortgages is considerably less than 10 years. An in-depth discussion of this issue is set forth below.

### B. Standardized Approach Unnecessary and Excessive in Light of Capital Strengthening Required by Basel III Numerator NPR

The requirements in the Standardized Approach NPR should not be considered in isolation but instead "should be considered together with changes proposed in the separate Basel III [Numerator] NPR."[3] The Basel III Numerator NPR, by itself, would substantially strengthen all U.S. banking organizations' minimum required capital base. Given this substantial strengthening of capital standards in the Basel III Numerator NPR, any additional capital benefit to be gained by also adopting the standardized approach is marginal at best. While the International Basel II standardized approach could theoretically result in better correlations of capital with risk for some assets, that outcome is far from clear with respect to the Standardized Approach NPR. Given the substantial strengthening in overall capital standards required by the Basel III Numerator NPR, there is far less need to impose the burdensome adjustments required by the standardized approach on all banking organizations.

[2] Standardized Approach NPR at 52,933.

[3] Standardized Approach NPR at 52,935.

### C. Standardized Approach NPR Neither Required by Nor Fully Consistent with International Basel Standards

Because the international Basel capital accords are required to apply only to "internationally active" banks, the United States has never agreed, in signing these accords, to apply these standards to U.S. banking organizations that are not internationally active.[4] U.S. banking regulators have nevertheless voluntarily imposed parts of the international Basel capital framework on non-internationally active banks for many years, including International Basel I[5] itself. But U.S. banking regulators have also long declined to apply other parts of the framework to non-internationally active banks, including, until now, the standardized approach first introduced in International Basel II. Thus, there should be no suggestion that U.S. regulators are bound, either formally or informally, to adopt the standardized approach for non-internationally active U.S. banking organizations—or, for that matter, for internationally active U.S. banking organizations, because these organizations are already required to comply with the advanced approaches in International Basel II. Accordingly, it is fully within the discretion of the Agencies, and fully consistent with the international Basel capital accords, to continue *not* to apply the standardized approach to U.S. banking organizations. Moreover, as discussed above, the Standardized Approach NPR—particularly the proposed risk weights for residential mortgage exposures—deviates significantly from the standardized approach agreed to by the Basel Committee.

## II. Conduct Empirical Study to Calibrate Risk Weightings and to Evaluate Impact of Changes on the U.S. Economy and Banking Industry

The Standardized Approach NPR would dramatically change capital requirements for all banking organizations, large and small, and would substantially deviate from the standardized approach agreed to in the international Basel capital framework. These changes in risk weights would have a substantial impact on the way that banking organizations conduct their business, yet the proposal provides no empirical evidence for such sweeping changes to the general risk-based capital rules. Where such differences in risk weights are clearly correlated and carefully calibrated to real differences in risk, those proposed changes would have benefits that could be justified. But where they are not, or where the Agencies simply assert such correlation and calibration, then the proposed changes should not be

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[4] *See, e.g.*, Basel Committee. *Report to G20 Leaders on Basel III Implementation*, 14-16 (June 2012), *available at* http://www.bis.org/publ/bcbs220.pdf (explicitly directing the international Basel capital framework at "internationally active" banks and noting that "Basel Committee member countries are not required, therefore, to apply the framework to all their banks").

[5] International Basel I refers to the international capital accord reached by the Basel Committee in *International Convergence of Capital Measurement and Capital Standards* (July 1988), *available at* http://www.bis.org/publ/bcbs04a.pdf.

adopted—especially where they could likely have a very significant impact on credit activities vital to the recovery of the U.S. economy.

For example, the proposed changes to risk weights for first and second residential mortgages are dramatic and perhaps unprecedented in both the scale and scope of change versus existing rules. These changes would in some cases impose considerably higher risk weights on some types of secured performing mortgages than would be applied to unsecured loans and to nonperforming and delinquent loans. Such changes could have a profound effect on the way that institutions provide mortgages, which in turn could result in far greater incentives to sell loans to government-backed entities and to reduce the bank holdings of such loans; far fewer loans being extended to all but the most creditworthy; and a substantial reduction in home equity lending—which, despite recent losses, continues to be an important on-balance sheet business for a broad range of banking organizations, from large to small.

Yet despite these potentially far-reaching changes, the Agencies offer only conclusory statements to justify the new risk weights and provide no empirical support for the changes.[6] The Agencies have not conducted an empirical study to evaluate the impact of their proposals on the banking industry, consumer and commercial borrowers, or the overall economy. The proposed rules, their unexpectedly broad scope and any data supporting such rules also were not discussed with industry participants or the public prior to being proposed. This is inconsistent with past practice. The Agencies have previously performed U.S.-specific empirical studies before implementing international Basel capital accords that have already been subject to international quantitative impact studies.[7] Here, in contrast, many provisions of the Standardized Approach NPR were never proposed or studied by the Basel Committee.

Empirical evidence should be required to justify the sweeping changes contemplated in the Standardized Approach NPR. Accordingly, the Associations strongly urge the Agencies to withdraw the current Standardized Approach NPR and to perform, publish and allow comments on a comprehensive empirical study of the Agencies' proposals prior to deciding the path for the NPR's implementation. An empirical study would provide much-needed data to help determine whether this proposed fundamental re-tooling of the generally applicable risk-based capital framework would be worthwhile based on the empirical impact

[6] The Associations urge the publication for notice and comment of any supporting data or empirical analysis relied upon by the Agencies, however limited such data or analysis may be.

[7] For example, the Agencies developed and tailored a version of QIS-4 specifically to determine the impact of International Basel II on U.S. banking organizations after a broader QIS-3 was developed for use in in several countries. *See* Federal Reserve Board, *Summary Findings of the Fourth Quantitative Impact Study* (Feb. 24, 2006), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20060224aa.htm ("QIS-4 was a more tailored study than QIS-3. While QIS-3 and QIS-4 were constructed for use in several countries and were coordinated through the Basel Committee, the Agencies developed and tailored a version of QIS-4 specifically for U.S. institutions.").

on bank capital requirements and the burden on the U.S. banking system and the broader U.S. economy. The Associations welcome an opportunity to work with the Agencies on a comprehensive empirical study.

The Associations also strongly urge the Agencies to perform, publish and allow comments on an analysis of current and historical demonstrated risk to support any proposed changes to current risk weights and deviations from the international Basel capital framework. The results of such analysis would help ensure that proposed risk weights are calibrated to the actual risk of assets and relative risk among asset classes. Empirical data and analysis would also provide a rational basis to support any proposed changes and to defend against a potential legal challenge that the proposed rules are arbitrary and capricious.

Where the limited data available do not support a proposed change, the Associations urge the Agencies to defer implementing such a change until more comprehensive data become available. To this end, the Associations suggest an observation period to obtain the necessary data to analyze the proposed changes to the current general risk-based capital framework. Importantly, where proposed risk weightings are not or cannot be justified by empirical data and analysis, the Associations urge the Agencies to abandon the proposed change.

Finally, the Associations believe that the Agencies are in the best position to gather industry-wide information for this empirical analysis, protect its confidentiality with respect to individual institutions and their customers, conduct the empirical analysis and publish the results to the public and the industry. Although such a data collection exercise would be highly burdensome to the industry, the Associations believe the burden would be significantly outweighed by the benefit of more calibrated risk weights. The Associations also welcome the opportunity to participate in designing the data collection proposal.

## III. General Issues To Be Addressed in Any Re-proposal of the Standardized Approach NPR

If the Agencies re-propose the Standardized Approach NPR, the Associations believe that the re-proposal should address the following general issues that apply to all aspects of the standardized approach. First, any re-proposed rule should reduce the risk weight mismatch among asset classes that exists in the Standardized Approach NPR and should recognize recovery rates on loans secured by assets as well as the performance of loans in setting risk weights; empirical study is critical to gather the necessary information to accurately calibrate these risk weights. Second, the proposed 1,250 percent risk weight should be replaced with an institution-specific approach to better achieve a dollar-for-dollar capital charge on the riskiest assets.

### A. Reduce Risk Weight Mismatch Among Asset Classes

The Standardized Approach NPR imposes risk weights ranging from zero percent to 1,250 percent. The Agencies provide no empirical data to justify the particular risk weights chosen. Indeed, it is unclear whether the Agencies *could* justify the proposed risk weights using empirical data, because in many cases the proposed new regime does not appear to reflect the actual, observed risk of assets or the relative risk across asset classes. The Associations believe that any re-proposal of the Standardized Approach NPR should be based on the results of the empirical study recommended in this letter, comments and other empirical analyses. Such an approach would provide stronger empirical and legal support for any re-proposal and would better align actual and relative risk of assets with standardized risk weights to reduce the risk weight mismatch among asset classes.

The negative consequences of inaccurate risk weightings in the Standardized Approach NPR are serious and real. Banking organizations, as part of the risk and capital management functions, in some ways necessarily respond to the incentives that the Agencies create: it would therefore be undesirable for the Agencies to encourage unsafe and unsound practices by assigning higher risk weights to assets that may be less risky than lower risk-weighted assets. For example, the proposal promotes unsecured credit over secured home equity lines of credit ("**HELOCs**") without any explanation or empirical evidence that the former is inherently safer than the latter. Similarly, past due exposures receive a risk weight of 150 percent, while equity exposures receive risk weights of up to 600 percent—but again, without any evidence that equity exposures are four times riskier than delinquent loans.

Further, this risk weight mismatch would have a disproportionate impact on Community Reinvestment Act ("**CRA**") loans. The CRA promotes lending, investment and servicing in all communities. Banking organizations work with borrowers to find prudent, sustainable, and workable solutions to their credit needs; the credit solution often does not fit the "plain vanilla" mold favored by the Standardized Approach NPR. For instance, banking organizations currently make many category 2 residential mortgage loans in CRA communities. If the Standardized Approach NPR were adopted as proposed, banking organizations would be reluctant to make these secured, prudently underwritten category 2 mortgages because the capital charge would exceed the actual risk of such loans. Similarly, borrowers in CRA communities may contribute land instead of cash to an acquisition, development, or construction ("**ADC**") CRE project. The Standardized Approach NPR would assign a 150 percent risk weight to such loans—the same risk weight as for past due exposures—even though such loans plainly are lower risk because the borrower is current on payments and contributes capital in the form of land to the project. The proposal therefore penalizes these CRA loans by assigning high risk weights that overstate the actual risk of such loans.

The Associations strongly believe that, before re-proposing material changes to risk weights, the Agencies should provide a credible empirical basis for doing so. Given the potential for a damaging misallocation of banking resources, it is simply not adequate for such changes to be made on intuitive judgments or conclusory statements. Changes in risk weights should be correlated and calibrated as much as possible to actual differences in risk.

### B. Recognize Performing Loans as Less Risky than Nonperforming Loans

The Standardized Approach NPR fails to recognize that performing, income-producing loans are less risky than delinquent loans. Rather than assign lower risk weights for performing loans, the proposal assigns high risk weights for nonperforming loans and even higher risk weights for some performing loans.

For example, the proposal generally assigns a 150 percent risk weight to exposures that are 90 days or more past due. The proposal assigns the same 150 percent risk weight to portfolios of performing high volatility CRE exposures (see discussion below) and assigns up to a 200 percent risk weight to portfolios of performing category 2 mortgages. The Agencies have provided no data demonstrating that these high risk weights reflect the actual or relative riskiness of these performing, income-producing portfolios when compared with past due loans.

Any re-proposal of the Standardized Approach NPR should therefore assign lower risk weights to performing, income-producing assets than to past due exposures, unless empirical analysis clearly demonstrates that such loans are of higher risk than past due loans when viewed as a portfolio.

### C. Maximum Risk Weight Should Not Exceed the Equivalent of a Dollar-for-Dollar Capital Deduction

Risk-weighted assets and capital deductions work in tandem to ensure that banking organizations limit their exposures to potentially loss-generating assets. As the risk weight for an exposure increases in the denominator, a banking organization is required to hold a greater amount of capital against the exposure, ensuring that the organization has adequate resources to absorb potential losses. For exposures to assets that raise particular concerns, a risk weight may not apply to the asset; instead, the banking organization may be required to take a capital deduction from the numerator matching the full value of the asset. In this circumstance, the banking organization is required to withhold enough capital to absorb the loss of the entire amount of the asset; its regulatory capital is therefore reduced "dollar for dollar" by the amount of the asset.

The Standardized Approach NPR attempts to achieve this result by assigning a 1,250 percent risk weight to certain exposures. If a banking organization is subject to a total capital to total risk-weighted assets requirement of 8 percent, a risk weight of 1,250 percent is equivalent to a dollar-for-dollar capital deduction because the amount of capital required to be held against the exposure is the same amount as would be required to accomplish a dollar-for-dollar deduction from capital (*i.e.*, 8 percent of 1,250 percent is 100 percent). Accordingly, whether a banking organization is required to assign a 1,250 percent risk weight to an exposure in the denominator or take a capital deduction in the numerator, the regulatory capital rules are intended to achieve the result that the amount of regulatory capital required to be held against an asset is equal to but not greater than the value of that asset.

As proposed, however, the Standardized Approach NPR could result in situations where a banking organization would be required to apply risk weights that assume potential losses greater than the full amount of the organization's exposure. Notwithstanding the fact that the Basel III Numerator NPR would raise banking organizations' total capital requirements from 8 percent to 10.5 percent (taking into account the capital conservation buffer), the Standardized Approach NPR would impose a flat maximum risk weight of 1,250 percent. For a banking organization subject to a 10.5 percent regulatory capital requirement, however, a 1,250 percent risk weight is equivalent to a capital deduction of 131 percent of the amount at risk (*i.e.*, 10.5 percent of 1,250 percent is 131 percent).

A banking organization should never be required to assume that it will suffer a loss greater than the amount of its exposure. Rather, the maximum risk weight applicable to an exposure should equal the equivalent amount of a full capital deduction. Requiring banking organizations to assume potential losses greater than a dollar-for-dollar capital deduction is illogical, especially in circumstances where the organization purchases an asset at fair market value in the open market (such as a securitization exposure) and could suffer losses no greater than the amount of its original purchase.

Because the Basel III Numerator NPR phases in higher capital requirements over time, the maximum risk weights under any re-proposal of the Standardized Approach NPR should be similarly phased in over time. As the total capital requirement rises above 8 percent (taking into account the capital conservation buffer), the maximum applicable risk weight should decline by the amount necessary to achieve a maximum risk-weight equivalent to a dollar-for-dollar capital deduction. Based on the transitional arrangements provided for in the Basel III Numerator NPR, the Associations recommend that the maximum risk weights applicable in any re-proposal of the Standardized Approach NPR be subject to similar transitional arrangements, as reflected in **Table B-1** below.

**<u>Table B-1</u>: Transitional Arrangements for Maximum Risk Weights and Comparison with Effective Capital Deduction**

| | January 1, 2013[8] | January 1, 2014 | January 1, 2015 | January 1, 2016 | January 1, 2017 | January 1, 2018 | January 1, 2019 |
|---|---|---|---|---|---|---|---|
| **Total Capital Ratio plus Capital Conservation Buffer** | 8.0% | 8.0% | 8.0% | 8.625% | 9.25% | 9.875% | 10.5% |
| **Transitional Maximum Risk Weight** | **1,250%** | **1,250%** | **1,250%** | **1,160%** | **1,081%** | **1,013%** | **952%** |
| **Effective Capital Deduction If Transitional Maximum Risk Weight Applies** | 100% | 100% | 100% | 100% | 100% | 100% | 100% |
| **Effective Capital Deduction If Proposed 1,250% Risk Weight Applies** | 100% | 100% | 100% | 108% | 116% | 123% | 131% |

The maximum risk-weighted assets transitional arrangements recommended by the Associations in **Table B-1** represent a reasonable, prudent approach to managing the dynamic interplay of regulatory capital with risk-weighted assets as capital standards increase in the coming years. The approach proposed by the Associations is consistent with other transitional arrangements in the Basel III Numerator NPR, which provide for stepped changes over a period of years, and avoids the illogical and punitive outcome of imposing risk weights that effectively require greater than a dollar-for-dollar capital deduction.

## IV. Residential Mortgage Exposures

The Associations recognize that poor underwriting and other problems in the residential mortgage market significantly contributed to the recent financial crisis. The Associations also appreciate the Agencies' attempts to address these concerns by revising the risk-based capital framework for residential mortgages. However, the proposed changes would hurt, rather than help, the residential mortgage market because they do not accurately reflect the actual or relative risk of certain types of residential mortgage loans. As a result, the Standardized Approach NPR would place banking organizations subject to U.S. capital requirements at a competitive disadvantage, create perverse incentives for excessive risk-

[8] These dates would change based on the timing of the empirical study recommended in this letter and the effective date of any final rule.

taking, retroactively punish existing loans, increase the cost of borrowing and reduce the availability of credit in the U.S. economy.

The Standardized Approach NPR assigns different risk weights to residential mortgage exposures based on (i) whether the mortgage is a "traditional" mortgage as redefined by the rule (category 1) or not (category 2); and (ii) the LTV ratio of the mortgage. Risk weights for category 1 mortgages vary from 35 percent to 100 percent, with higher risk weights associated with higher LTV ratios. Risk weights for category 2 mortgages range from 100 percent to 200 percent, with higher risk weights likewise depending on higher LTV ratios. These proposed risk weights are substantially higher than the 50 and 100 percent residential mortgage risk weights in the current risk-based capital requirements and make far more detailed distinctions among types of mortgages. Such sweeping changes to the risk weighting of residential mortgages are not supported by empirical data or analysis provided by the Agencies and would create perverse incentives for lenders.

In addition, the Standardized Approach NPR would place banking organizations subject to U.S. capital requirements at a competitive disadvantage because the proposed risk weights are significantly higher than residential mortgage risk weights in other developed countries implementing the international Basel capital framework. For example, a recent IMF working paper showed that risk weights for residential mortgage exposures in the United States are *already* the highest internationally—even before the imposition of the proposed higher risk weights.[9] The proposed mortgage risk weights of 35 percent to 200 percent are significantly higher than those in Canada (below 10 percent), Europe (14 percent) and Asia (15 percent).[10] Recent efforts to increase residential mortgage risk weights in these foreign jurisdictions would still result in lower risk weights overall than the lowest proposed risk weight of 35 percent for the perceived lowest-risk mortgages in the United States.[11] The Associations therefore request that the Agencies provide data or other analysis comparing the risks of residential mortgage exposures in the United States to those of other countries that would justify these large disparities in risk weights.

Moreover, the proposed category 1 risk weights for first mortgages are generally *higher* than those proposed by the Agencies in 2008 for *all* first-lien mortgages—despite the proposed removal of supposedly higher-risk mortgages from the overall pool of mortgages into a separate category. Likewise, the proposed category 2 risk weights are generally *higher*

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[9] *See* Vanessa Le Leslé and Sofiya Avramova, International Monetary Fund, *Revisiting Risk-Weighted Assets: Why Do RWAs Differ Across Countries and What Can Be Done About It?* (WP/12/90, Mar. 2012), *available at* http://www.imf.org/external/pubs/ft/wp/2012/wp1290.pdf.

[10] *Id.* at 22.

[11] For example. Sweden proposes to increase the risk weight from 6 percent to 20 percent for residential mortgages.

than those proposed by the Agencies in 2008 for *junior*-lien loans—even though the new category 2 would also include first-lien mortgages with a last loss position.[12]

Finally, the proposed changes in risk weights fail to take into account the more stringent underwriting standards that are otherwise required by the Dodd-Frank Act, many of which have already been adopted by banks due to their own experiences during the last cycle.[13] They also fail to take into account the general increase in capital requirements otherwise mandated by the Basel III Numerator NPR. Together, current and proposed underwriting and capital-related changes will make mortgages either too expensive for most ordinary consumers or simply unavailable to them.

Below, the Associations describe in more detail the issues raised by the Standardized Approach NPR that should be re-evaluated in the context of a comprehensive empirical study and addressed in any re-proposal of the Standardized Approach NPR.

### A. Proposed Rule Is Arbitrary, Not Supported by Empirical Evidence and Detrimental to the U.S. Economy[14]

The Associations believe that any re-proposal of the Standardized Approach NPR should be based on the results of a comprehensive empirical study, comments and other empirical analyses. Such an approach would be especially crucial with respect to residential mortgage exposures given the perverse incentives in the current Standardized Approach NPR and the broad impact that such rules would have on the U.S. economy.

#### 1. Proposed Mortgage Categories Are Arbitrary and the Agencies Have Failed to Provide Supporting Data

The preamble to the Standardized Approach NPR asserts that category 2 mortgages are subject to higher risk weights because they "generally are of higher risk," whereas category 1 mortgages "reflect those underwriting and product features that have demonstrated a lower risk of default both through supervisory experience and observations from the recent foreclosure crisis."

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[12] *Compare* OCC, Federal Reserve Board, FDIC and OTS, *Risk-Based Capital Guidelines; Capital Adequacy Guidelines: Standardized Framework*, 73 Fed. Reg. 43,982, 43,994-96 (July 29, 2008) ("**2008 Standardized Approach NPR**").

[13] *See, e.g.*, Dodd-Frank Act § 941 (excluding "qualified residential mortgages" from the credit risk retention requirements); Dodd-Frank Act § 1412 (defining "qualified mortgage").

[14] Schedule 1 to Annex B sets forth further detail regarding the characterization of residential mortgage exposures and the treatment of junior lien mortgages.

Despite these assertions, the proposed rule fails to present any empirical data or other evidence to support the assertion that category 2 mortgages present higher risks that might not have been addressed, and are not being addressed, by widespread changes to underwriting standards—many of which are or will be mandated by provisions of the Dodd-Frank Act and their implementing regulations, such as those relating to "qualified mortgages" and "qualified residential mortgages."

It may be obvious that, all other risk characteristics being held constant, mortgages with higher LTV ratios are riskier than ones with lower ratios. But all other risk characteristics, such as the wealth, income, credit score or debt-to-income ratio of a borrower, are not always constant—and it is just as obvious that these characteristics often have a profound effect on the actual risk of a particular loan that is quite different from the assessment that could be made by looking at the LTV ratio only or the presence of a particular risk factor in the underwriting process. Moreover, such risk characteristics affect the relative risk of a loan much more than the characteristics that distinguish a category 1 from a category 2 loan.

Given these other important underwriting characteristics, which are fundamental to the business of making loans, the proposed definition for category 1 mortgages is too narrow. For example:

- The Standardized Approach NPR does not specifically include "qualified mortgages" in category 1.[15] This approach that makes little sense. Like other category 1 mortgages, qualified mortgages are plainly intended to be structurally safer than other types of mortgages because they must be underwritten according to prescribed standards that make it reasonable to expect—presumptively—that the borrower has the ability to repay. It is incongruous for the government to carefully define a lower-risk mortgage in one context and then not specifically include such mortgages in a capital rule category designed to capture lower-risk mortgages. Failing to do so would not only be burdensome but would also undermine the shared purpose in both contexts of creating a recognized category of lower-risk loans. This is not to say that only "qualified mortgages" should receive non-punitive risk weights, since the definition of a qualified mortgage was not oriented toward determining risks and capital requirements for lenders.

- The Standardized Approach NPR excludes many lower-risk, prudently underwritten adjustable-rate mortgages ("**ARMs**") from category 1 and broadly sweeps such

[15] Section 1412 of the Dodd-Frank Act requires the establishment of a category of mortgages, called "qualified mortgages," that meet certain ability-to-repay requirements and are therefore shielded from at least some litigation risk. *See* Dodd-Frank Act § 1412 (adding Section 129C of the Truth in Lending Act). The rule implementing this statutory provision has not yet been finalized.

mortgages into high category 2 risk weights. While some types of ARMs caused higher losses during the crisis—particularly loans with exceptionally low teaser rates that were guaranteed to reset higher regardless of movements in the broader interest rate environment—more-traditional and hybrid ARMs have not been shown to present similar risks. Rather than narrowly tailor category 2 to address problems associated with deep teaser rates, the NPR imposes the higher, category 2 risk weights on all ARMs with fixed-rate periods of fewer than five years and all ARMs with initial rate increases of more than 2 percent as if they were teaser-rate ARMs. Part I.A of Schedule 1 to this section of the letter further discusses why the proposed treatment of ARMs is inappropriate.

- The Standardized Approach NPR also broadly sweeps in all interest-only and balloon-payment mortgages without acknowledging that these are specialty products that, if properly structured, can help borrowers who otherwise might be denied credit entirely or face prohibitively higher costs. For example, business owners may prefer an interest-only or balloon-payment loan so that they are not required to continuously build further equity in their homes, which may be adequate at origination, and instead apply their cash flows to building equity in their businesses, creating investment and jobs. Although interest-only and balloon-payment mortgages present the potential for slightly higher risks than other traditional mortgages, they have not demonstrated the inherent and structural risk presented by teaser-rate ARMs, negative-amortization mortgages, and other non-prime mortgages that resulted in so many losses in the last five years. Part I.B of Schedule 1 to this section of the letter further discusses why the proposed treatment of all interest-only and balloon-payment mortgages as high-risk category 2 mortgages is inappropriate.

- Many standard, prudently underwritten HELOCs would be deemed category 2 loans due to characteristics such as floating interest rates, interest-only periods and balloon maturities. This treatment is unwarranted given that banks offer HELOCs to higher-quality borrowers and HELOCs performed consistently with prime mortgage exposures even through the crisis.[16] Further, the proposal classifies a first-lien mortgage held by the same lender that made such a category 2 HELOC as a category 2 first-lien mortgage, thereby doubling the risk weight applicable to the first lien as well. This treatment of junior- and first-lien mortgages is discussed in greater detail in Part II of Schedule 1 to this section of the letter.

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[16] *See* Donghoon Lee, Christopher Mayer and Joseph Tracy, Federal Reserve Bank of New York, *A New Look at Second Liens* (Staff Report No. 569, Aug. 2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr569.pdf.

- The Standardized Approach NPR would also impose high, category 2 risk weights on all mortgages with greater than a 30-year maturity period.[17] Although some 40-year mortgages suffered losses during the financial downturn, 40-year mortgages are not inherently more risky than other types of mortgages. For borrowers who qualify for several loan products including 30-year fixed rate mortgages a 40-year mortgage can provide lower and more beneficial payments than a traditional 30-year mortgage. As with balloon-payment and interest-only mortgages, prudent underwriting and an understanding of the borrower's characteristics is far more important than the inherent structure of the loan.

In short, the Associations do not believe the proposed categories properly delineate the risk across different types of mortgages.

Further, the proposed mortgage categories reflect only U.S. residential mortgage types and do not contemplate mortgages U.S. banking organizations may make in foreign countries or purchase from foreign institutions. Mortgage originators in foreign countries are subject to the international Basel capital framework, which does not provide for detailed gradations in mortgage categories as proposed in the Standardized Approach NPR. Accordingly, foreign originators may not record information that would permit U.S. banking organizations to determine the correct mortgage category. Moreover, the proposed category 1 characteristics do not necessarily reflect or capture all low-risk residential mortgages in foreign countries. As a result, the proposed approach would force U.S. banking organizations to treat low-risk, low-default foreign mortgage portfolios as category 2 mortgages.

The Associations raise these concerns because the proposal appears to overcompensate for past problems at the expense of current residential mortgage borrowers and lenders. The Associations do not dispute the fact that residential mortgages produced sizeable and unexpected losses in the wake of the housing bubble and the financial crisis, although generally not at the levels implied by the high risk weights ascribed to many mortgage loans in the Standardized Approach NPR. But in light of the fact that capital requirements are otherwise increasing substantially for all institutions in the proposed Basel III Numerator NPR, and in light of the fact that mortgage underwriting standards have already tightened substantially, the Associations believe that it is also possible to overcorrect for past problems. This includes the cumulative effect of increasing general capital ratio requirements and tightening underwriting standards under new regulations for "qualified mortgages" and "qualified residential mortgages," and then adding the effect of lumping whole classes of mortgages into higher risk weight buckets without adequately correlating these buckets to increases in actual risk. Where such overcorrection occurs, lenders are penalized for making

[17] Basel III Numerator NPR § ___.2 (Definitions).

mortgages that may and should be made in a safe and sound manner, with negative consequences for borrowers and the economy.

### 2. Proposed Risk Weights Are Too High and Do Not Reflect the Actual or Relative Risk of Residential Mortgage Exposures

The Standardized Approach NPR provides substantial risk weight increases for category 2 mortgages. The proposed category 2 risk weights ranging from 100 percent to 200 percent are too high and bear little relation to the actual risk of such mortgages or to the relative risk of such mortgages compared with other assets. Again, the Agencies have not presented any empirical evidence to support the proposed increases or the relative calibration among risk weights. For example:

- The Standardized Approach NPR fails to explain or provide substantial evidence to support why all category 2 mortgages with risk weights exceeding 100 percent—all of which are secured—deserve significantly higher risk weights than, for example, unsecured consumer loans, student loans not reinsured by the U.S. Department of Education, CRE loans and leveraged loans, all of which receive a 100 percent risk weight under the Standardized Approach NPR.

- The Standardized Approach NPR imposes a 200 percent risk weight on a category 2 mortgage with more than a 90 percent LTV ratio. By contrast, the proposal assigns a 150 percent risk weight to past due exposures. The proposal provides no data or empirical support to suggest that a collateralized, income-earning residential mortgage is more risky than a delinquent loan.

The Standardized Approach NPR also fails to provide empirical analysis justifying the substantial risk weight differences between category 1 and category 2 mortgages. For example:

- The Standardized Approach NPR assigns a 100 percent risk weight to a category 2 mortgage with a 60 percent LTV ratio, versus a 35 percent risk weight to a category 1 mortgage with a 60 percent LTV. There is no evidence that a category 2 mortgage, such as a hybrid ARM, interest-only or balloon-payment mortgage, is nearly three times as risky as a category 1 mortgage with the same, low LTV ratio. The collateral position of any loan at such a low LTV would substantially mitigate its loss characteristics.

- Similarly, there is no evidence that a category 2 mortgage with a 60 percent LTV ratio is as risky as a category 1 mortgage with a 95 percent LTV ratio. Yet, both mortgages receive a 100 percent risk weight under the Standardized Approach NPR.

The substantial difference in risk weights between category 1 and category 2 mortgages also heightens the "cliff effect" when mortgages shift between and within the two categories. Under the Standardized Approach NPR, any change that causes a mortgage to move from category 1 to category 2 will result in a substantial and sometimes excessive capital increase. Under the proposal, for example, the risk weight applicable to a category 1 first-lien mortgage with a 70 percent LTV ratio doubles from 50 percent to 100 percent if the borrower takes out a category 2 junior lien on the same property from the same lender, even where the junior lien would only increase the cumulative LTV ("**CLTV**") ratio to 80 percent. The increase in a banking organization's risk-weighted assets, attributable to having made the junior lien, would be 450 percent of the size of the junior lien (*i.e.*, an effective 450 percent risk-weighting on the junior lien).[18] In contrast, another potential lender of the junior lien loan would only attribute 100 percent risk-weighting to the same 80 percent CLTV junior lien. This type of capital increase is disproportionately high relative to the increase in risk and would substantially reduce the availability of junior liens, such as home equity loans and lines of credit. As a result, banking organizations would have a perverse incentive to release liens on junior-lien mortgages to prevent the junior lien from "tainting" the first lien into a category 2 mortgage, or to make unsecured loans instead of home equity loans behind a first-lien mortgage. This would seem necessary to remain competitive with alternative providers of junior liens. Part II of Schedule 1 to this section of the letter further discusses the enormous and unwarranted impact the Standardized Approach NPR would have on first- and junior-lien mortgages.

These substantial actual and relative increases in risk weights would significantly impact the types of loans that institutions will make, even where prudent underwriting and equity in the home would mitigate the presumed risk. Where such changes are reasonably calibrated to relative risk, that change in behavior may be warranted. But where such changes are not so calibrated, or where the particular calibrations are based only on assertions or intuition rather than empirical evidence, then the Associations submit that such changes are not warranted and would reduce the availability of credit based on lenders' aversion to punitive capital treatment rather than an aversion to actual risk.

Further, the high proposed risk weights provide certain incentives for banking organizations to engage in riskier lending and may drive less risky lending activities to the non-banking sector. Bank capital should support and correlate with risk, and rules that keep capital close to the level of the actual risk create the right incentive for prudent risk management. However, overly punitive rules that impose capital charges that do not reflect underlying risks create an incentive for banking organizations to generate more earnings through riskier activities to compensate for the higher level of required capital. By requiring

[18] $[(1.00 \times 80) - (0.50 \times 70)] / 10 = 4.50$

disproportionately higher capital to be held against safer activities, the regulations will make such activities unprofitable and create incentives for banking organizations to take greater credit risk elsewhere. For instance, the Standardized Approach NPR assigns a 100 percent risk weight to a 40-year, interest-only loan with a 50 percent LTV ratio. This 100 percent risk weight likely overstates the actual risk of the loan for most borrowers and therefore imposes a punitive capital charge on the banking organization. As a result, banking organizations may find that the required pricing for such loans is economically justifiable only if they are made to lower-credit quality borrowers to compensate for the high capital charge. Safer lending will become less profitable and will therefore tend to move out of the regulated banking sector into the non-banking sector.

Residential mortgages are too important a business to banking organizations, and too important a product for consumers and the economy, for such dramatic changes to be made without considerably more empirical support—especially when International Basel II itself includes no such granular calibrations for different types of mortgage risk. The Associations again request that the Agencies conduct a comprehensive empirical study to better calibrate risk weights with the actual risk associated with mortgage loans.

### 3. Standardized Approach NPR Would Have Substantial and Detrimental Impact on U.S. Consumers and the Overall Economy

The proposed rules for residential mortgage exposures in the Standardized Approach NPR would dramatically increase the amount of capital required to be held against residential mortgage assets. The increase in required capital would inevitably:

- Reduce the amount of credit provided to homeowners;
- Substantially increase pricing, including significant interest rate increases, for residential lending for all but the lowest-risk borrowers with the lowest levels of borrowing against their homes;
- Penalize lending to a broad range of customers in conflict with the CRA and fair lending laws;
- Incentivize riskier lending; and
- Place the U.S. banking sector at a competitive disadvantage because the treatment of residential mortgage exposures is inconsistent with International Basel II.

Additionally, Congress, the President and the Agencies all have expressed a desire to remove or reduce the role of the GSEs in carrying the ultimate risk of losses on mortgages in the United States. The proposal makes the achievement of this policy objective significantly less likely by:

- Dramatically increasing the cost of holding mortgages;
- Discouraging mortgages and practices that mitigate risks to banking organizations (such as floating-rate mortgages and private loan modifications); and
- Effectively requiring significantly higher pricing in order to make holding additional mortgages a sustainable and safe and sound bank practice.

Finally, the higher proposed risk weights for residential loan modifications and for delinquent and nonaccrual loans would greatly magnify the level of pro-cyclicality already inherent in the banking industry. When economic conditions deteriorate, more borrowers will need loan modifications or will become delinquent—a possibility inherent in the standard risk weights for all loans. The Standardized Approach NPR would instead impose higher risk weights on loan modifications and delinquent loans, causing banking organizations to reduce credit lines, sell assets and hold on to capital at the very time credit is most needed in the economy. The impact of this pro-cyclical risk-weighting methodology is compounded by the "mark-to-market" method proposed in the Basel III Numerator NPR, as all market gains and losses on AFS securities flow through to CET1. Together, the two NPRs would magnify business cycles—especially during times of economic contraction.

Introducing such dramatic changes at a time when the recovery in the housing sector is exceptionally fragile presents significant and unwarranted economic risk.

### B. Any Re-proposal of the Standardized Approach NPR Should Be Based on Empirical Study and Other Empirical Analysis

Given the broad impact of the proposed mortgage rules on U.S. consumers, the banking industry and the economy as a whole, it is disappointing that the Standardized Approach NPR has not been based on published, empirical evidence to justify such significant changes. The Associations thus reiterate the necessity of an empirical study to determine the appropriate level for any proposed changes to risk weights for residential mortgage exposures and to incorporate such findings into any re-proposal of the Standardized Approach NPR. Rigorous and controlled empirical analysis is especially necessary in light of the stringent underwriting standards adopted by banking organizations following the financial crisis and the general increase in capital requirements proposed in the Basel III Numerator NPR.

At a minimum, any re-proposal of the Standardized Approach NPR should:

- Eliminate the arbitrary distinction between category 1 and category 2 mortgages and instead distinguish solely between first- and junior-lien mortgages;

- Evaluate first-lien and junior-lien mortgage exposures separately, unless the junior-lien mortgage is originated and funded at the same time as the first in a "piggyback" loan;

- Clarify that the credit conversion factor ("**CCF**") applies to the unfunded portion of a held residential mortgage exposure for purposes of calculating the numerator of the LTV ratio;

- Grandfather all legacy exposures;

- Recognize all sustainable loan modifications, whether or not they are part of the Home Affordable Modification Program ("**HAMP**");

- Recognize private mortgage insurance ("**PMI**") at the individual and pool-wide level; and

- Maintain the 120-day safe harbor for credit-enhancing representations and warranties in the current risk-based capital rules.

Set forth in more detail below are the concerns precipitating the request for these changes to the Standardized Approach NPR (which should be reflected in any re-proposed rule), as well as more detail about each recommended change.

**1. Eliminate Proposed New Mortgage Categories and Replace With Simpler Approach that Distinguishes Between First- and Junior-Lien Mortgages**

As described above, the proposed mortgage categories are arbitrary and bear little relation to actual mortgage losses that lenders experienced during the financial crisis. The proposed definition of category 1 mortgages is too narrow and excludes many types of lower-risk, prudently underwritten products with historical loss trends much more in line with the traditional mortgages included in category 1 than category 2. In an attempt to require higher capital on a very narrow subset of legitimately higher-risk products, the NPR overreaches and causes a significant number of lower-risk, prudently underwritten products to be considered category 2 exposures.

Rather than distinguish between arbitrary mortgage category designations, any re-proposal of the Standardized Approach NPR instead should distinguish between first-lien and junior-lien mortgages, depending on their LTV and CLTV ratios. For example, the existing risk-based capital rules assign a 50 percent risk weight to most first-lien mortgage exposures and a 100 percent risk weight to junior-lien mortgage exposures. Similarly, the 2008 Standardized Approach NPR proposed risk weights ranging from 20 percent to 150 percent for first-lien mortgages and 75 percent to 150 percent for junior-lien mortgages, depending on the LTV ratio.[19]

The Associations believe that this distinction between first- and junior-lien mortgages, rather than between mortgage categories, is more appropriate for at least two reasons. First, as a general matter, junior-lien mortgages are more risky than first-lien mortgages because they bear first risk of loss relative to a senior lien and, accordingly, should receive higher risk weights. The Associations believe that such an approach would better capture the actual and relative risk among different types of mortgage exposures. Second, such an approach would avoid the perverse incentives created by the arbitrary mortgage categories in the Standardized Approach NPR discussed throughout this section of the letter and in Schedule 1.

The Associations have not proposed specific risk weights for first- and junior-lien mortgages because the Associations believe it would not be appropriate to recommend risk weights without data to support and calibrate them. Nonetheless, the Associations strongly recommend that any re-proposal of the Standardized Approach NPR include finer gradations between LTV ratios to determine risk weights. A more granular approach, such as the six proposed LTV tiers in the 2008 Standardized Approach NPR for first-lien mortgage exposures,[20] would reduce cliff effects between tiers for both senior and junior liens and would reduce regulatory arbitrage.

### 2. Evaluate First-Lien and Junior-Lien Mortgage Exposures Separately

The Associations emphasize that any re-proposal of the Standardized Approach NPR not only should distinguish between first- and junior-lien mortgages but also should evaluate first- and junior-lien mortgages separately, unless the first- and junior-lien mortgages are originated simultaneously. In other words, a simultaneously originated and funded piggyback junior-lien mortgage would "taint" the first into a higher risk weight (due to using the combined CLTV for both exposures), but a subsequently made, junior-lien mortgage would not. This distinction is important given experience with piggyback lending relative to other types of home equity lending, and also given the recent study by the Federal Reserve Bank of

[19] 2008 Standardized Approach NPR at 44,040. The Associations argued then and still believe that the 150 percent risk weighting for higher LTV first-lien mortgages was too high and also believe that a carefully designed calibration exercise would demonstrate this for most portfolios of first-lien mortgages. Likewise, the Associations argued then and still believe that most junior-lien home equity loans should also be assigned a risk weighting well below the 150 percent maximum proposed in 2008.

[20] *See* 2008 Standardized Approach NPR at 43,995.

New York that distinguishes between piggyback junior liens and HELOCs originated after the first-lien mortgage.[21]

As proposed, the Standardized Approach NPR allows a junior-lien mortgage to taint the risk weight of a first-lien mortgage on the same property held by the same banking organization (through both increasing the LTV used for the first lien and potentially changing its category), regardless of whether the junior lien is a subsequent HELOC or a piggyback home equity loan. Specifically, the proposed rule provides that "[i]f a banking organization holds two or more mortgage loans on the same residential property, and one of the loans is category 2, then the banking organization would be required to treat all of the loans on the property as category 2."[22] The proposed rule also defines a first-lien residential mortgage exposure to include a mortgage secured by first and junior lien(s) where no party holds an intervening lien.[23]

The Standardized Approach NPR fails to explain why a junior-lien mortgage extended by the same institution that holds a first-lien mortgage on the same property would increase (possibly dramatically) the required capital for the first-lien mortgage, but a junior-lien mortgage extended by a third-party institution would have no impact on the first-lien mortgage. This disparate treatment of identical loans made by different banking organizations makes little sense and certainly does not reflect a meaningful difference in risk. Indeed, if anything, it is less risky for a lender that already understands the creditworthiness of a first-lien customer to extend a junior-lien loan to that customer, as opposed to a third-party lender that may have had no previous contact with the borrower. This has been recognized by banking organizations and regulators for many years, and the Associations believe that nothing learned during the recent crisis suggests otherwise.

Additionally, it is very common for a borrower to obtain a HELOC from the same lender that provided a first mortgage on the property. Under the proposal, such lenders would be reluctant to extend a home equity loan or HELOC to their existing customers, because it would raise the LTV used to risk-weight the (usually much larger[24]) first mortgage (even though the first mortgage would retain its senior position in the collateral). And, if the second lien were a category 2 loan, it would also shift the first lien to category 2 with further,

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

[22] Standardized Approach NPR at 52,939.

[23] Basel III Numerator NPR § ___.2 (Definitions).

[24] Total second lien balances represent 10 percent of the total balances of first liens. *See* Donghoon Lee, Christopher Mayer and Joseph Tracy, Federal Reserve Bank of New York. *A New Look at Second Liens*, 1 (Staff Report No. 569, Aug. 2012).

substantially higher risk weights. As a result, first mortgage customers would be driven to different banking organizations to obtain their home equity loans and lines of credit, significantly disrupting normal channels of credit provision. This would damage the relationship between customers and banks, through no fault of either party.[25]

Nonetheless, the Associations agree that junior-lien loans are typically riskier than first-lien loans and, accordingly, warrant a higher risk weight. However, the Associations strongly disagree that *all* junior lien mortgages should taint the first lien into a higher risk weight. The recent study by the Federal Reserve Bank of New York confirms this position. This study found that lenders provided HELOCs primarily to higher-quality borrowers and underwrote the loans to the credit quality of the borrower and not just the value of the home; as such, these junior liens generally performed consistently with prime mortgage exposures.[26] By contrast, closed-end junior liens originated simultaneously with a first lien in a piggyback loan often were originated to borrowers with low credit scores to lower the borrower's initial down payment.[27]

Accordingly, any re-proposal of the Standardized Approach NPR should treat first and junior mortgages separately, unless the junior lien is originated and funded simultaneously with the first-lien mortgage in a piggyback loan. A "first-lien residential mortgage exposure" therefore should be defined as "a residential mortgage exposure secured by a first lien or a residential mortgage exposure secured by first and junior lien(s) that were originated on the same day."[28] Consistent with the current proposal, a junior-lien residential mortgage exposure would mean "a residential mortgage exposure that is not a first-lien residential mortgage exposure,"[29] such as a HELOC originated after the first-lien mortgage.

The Associations believe that, while a number of the proposed rules would severely hamper the availability of credit, the proposed treatment of junior liens so that they taint first liens may have the greatest potential to generate truly perverse outcomes in the residential

[25] It may prove impossible for the banking organization holding the first mortgage to explain to the customer why it cannot make the junior lien loan or cannot do so at competitive pricing, relative to another lender's ability to make the loan at better pricing, because the issue is not based on risk but rather on the unwarranted effects of the Standardized Approach NPR.

[26] *See* Donghoon Lee, Christopher Mayer and Joseph Tracy, Federal Reserve Bank of New York, *A New Look at Second Liens*, 3, 6-7, 11-12 (Staff Report No. 569, Aug. 2012).

[27] *See id.* at 6, 11-12.

[28] *Compare* Basel III Numerator NPR § ___.2 (defining "first-lien residential mortgage exposure"). A junior lien that is re-subordinated upon the refinancing of a first lien, and that was not originally a piggyback loan, should retain its status as a subsequent junior lien (*i.e.*, it would retain its nature as having been made subsequent to the financing purpose of the first lien).

[29] *See* Basel III Numerator NPR § ___.2 (defining "junior-lien residential mortgage exposure").

mortgage market. There is nothing like it in the international Basel capital framework, and it is counter to actual risk characteristics of the second mortgage business. The Associations cannot stress highly enough how critical it is that these influences of junior liens on senior liens be removed in order to avoid significant adverse outcomes for the U.S. economy. Therefore, any re-proposal of the Standardized Approach NPR should evaluate first and junior liens separately unless the junior lien is originated on the same day as the first lien in a piggyback loan.

### 3. Clarify the LTV Calculation for Unfunded Portions of a Residential Mortgage Exposure

The Standardized Approach NPR would assign a risk weight to a residential mortgage exposure depending on the LTV ratio of the exposure. The Associations request clarification in any re-proposed rule that the CCF for the unfunded portion of a held residential mortgage exposure would apply to the numerator of the LTV ratio as well as the overall exposure amount being risk-weighted. This clarification would have a large capital impact on banking organizations.

For example, assume that a property is valued at $100,000 when a bank originates a $25,000 HELOC subordinate to a $60,000 closed-end, funded first lien exposure; that $10,000 of the HELOC is funded and $15,000 remains unfunded; and that a zero percent CCF applies to the unfunded portion of the HELOC. The numerator in determining the LTV of the junior lien HELOC should be the sum of (i) the $60,000 maximum exposure of the first lien, (ii) the $10,000 funded balance on the HELOC, and (iii) the $15,000 unfunded commitment multiplied by the zero percent CCF. This method would result in an LTV ratio of 70 percent[30] for purposes of determining the applicable risk weight percentage for the junior lien exposure. Under the Standardized Approach NPR, a 70 percent LTV ratio for a junior lien mortgage would result in a 100 percent risk weight,[31] which would be applied to the $10,000 junior lien exposure.[32] To the extent the CCF of a given exposure is not zero percent (*e.g.*, negative amortization exposures that are not deemed unconditionally cancelable), the unfunded commitment would draw a higher capital allocation. As discussed above, the $60,000 first lien exposure would continue to receive a 35 percent risk weight and would not be combined with the junior lien exposure.

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[30] [$60.000 + $10.000 + ($15,000 x 0)] / $100,000 = 0.70.

[31] *See* Standardized Approach NPR, 77 Fed. Reg. 52,951, § __.32(g).

[32] $10,000 + ($15,000 x 0) = $10,000.

This method is similar to that proposed by the Agencies in the 2008 Standardized Approach NPR,[33] but is simpler because it would result in a single LTV and associated risk weight determination. The Associations therefore request the Agencies to clarify in the re-proposed rule that the CCF be applied to the unfunded amount of a held residential mortgage exposure for purposes of calculating the numerator in the LTV calculation as well as the overall exposure being risk-weighted.

### 4. Grandfather All Legacy Mortgage Exposures

Any re-proposal of the Standardized Approach NPR should grandfather all existing mortgage exposures by assigning them risk weights as required under the current general risk-based capital requirements. Grandfathering such mortgages is appropriate for at least three reasons.

First, many banking organizations will not have the data necessary to assign mortgage categories under the Standardized Approach NPR or any similar re-proposal. The proposed mortgage categories did not exist at the time these mortgages were originated, and thus the originator might not have recorded the data or other information that would allow the current holders of such mortgages to assign the appropriate risk weight. Information about underwriting criteria will be particularly difficult—if not impossible—to obtain. For example, the proposal defines a category 1 mortgage to mean one in which the "standards used to underwrite the residential mortgage exposure . . . [t]ook into account all of the borrower's obligations, including for mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance), and assessments."[34] Although a banking organization may well have taken these considerations into account at origination, they were not always documented because they were not required to be.

Second, even if a banking organization has the data necessary to calculate the risk weights applicable to each mortgage, it would be extremely burdensome for many banking organizations—the extent of which would be scaled to the number of exposures—to examine old records in order to determine mortgage categories and calculate LTV ratios under the proposed framework. For example, bank staff would be required to go through decades-old loan files to determine appraisal values and borrower characteristics to determine the appropriate risk weight.

Third, the retroactive impact of the proposed treatment would be especially harsh due to the substantial increase in capital that would be required for existing category 2 mortgages. Given that it has not been documented that the actual risk of these mortgages correlates with

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[33] *See* 2008 Standardized Approach NPR at 43,996 (example of LTV calculation).

[34] Standardized Approach NPR at 52,939; Basel III Numerator NPR § ___.2 (Definitions).

the amount of risk implied by the proposed new risk buckets, and given that the Basel III Numerator NPR is already substantially increasing the required minimum capital, the need for retroactive application of the new standards is significantly attenuated. While institutions can adjust their lending practices with respect to newly issued mortgages, they cannot do so with respect to mortgages already made.

Finally, existing loans that have been on a banking organization's books and that have satisfactory payment records demonstrate that a borrower is able to maintain current payments and is likely to continue to make payments. Such seasoned, performing loans are less likely to default and are less risky than newly originated loans.

Accordingly, existing mortgages should be grandfathered and allowed to roll off using existing risk weights, with the new standards phasing in with the provision of new mortgages over time. Since the average life of mortgages is considerably less than 10 years, the resulting phase-in period would not be excessively long and would be consistent with both safety and soundness and fundamental fairness.

### 5. Recognize All Sustainable Loan Modifications

The Standardized Approach NPR generally requires a banking organization to recategorize a mortgage as category 1 or category 2 according to the terms and characteristics of the mortgage after modification or restructuring and to revalue the loan's LTV ratio.[35] However, it exempts modifications and restructurings under HAMP from this requirement. Mortgages that have undergone HAMP modifications or restructurings would not be considered modified or restructured and would retain the same risk weight assigned to the mortgage at the time of origination. The rationale for the exemption is that HAMP modifications "achieve the public policy objective of promoting sustainable loan modifications for homeowners at risk of foreclosure in a way that balances the interests of borrowers, servicers, and lenders."[36]

The Associations strongly agree with the statement in the preamble to the Standardized Approach NPR that 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."[37] Importantly, however, HAMP is not unique in achieving these objectives. Many

[35] The Associations seek clarification in any re-proposal of the Standardized Approach NPR that the term "modification or restructuring" does not include general forbearance plans or voluntary deferrals that postpone payment for a short period of time without changing the terms and conditions of a loan. Instead, the term should be reserved for formal adjustments or changes to the terms and conditions of a loan agreement.

[36] Standardized Approach NPR at 52,900.

[37] *Id.*

private, non-government-sponsored modifications can be and are being structured to be at least as likely as HAMP to create sustainable, performing loans.

However, the Standardized Approach NPR penalizes most modifications (as most modifications are not done under HAMP) because they would result in risk weights of up to 200 percent due to recategorization and potentially higher LTV ratios. By contrast, if a banking organization did not modify the mortgage, the loan would maintain its existing categorization, property valuation and lower risk weight. Alternatively, if the loan became past due without a modification, it could still be assigned a lower risk weight than if the loan were modified.[38] The resulting disincentive to modify is perverse because it would discourage modifications that would help borrowers avoid default through reduced monthly payments, which in turn would reduce risk for lenders.

Any re-proposal of the Standardized Approach NPR should instead promote sustainable private modifications and restructurings by expanding the exemption provided to HAMP modifications to encompass a broader array of modifications and restructurings that meet certain criteria to promote the sustainability of the loans. That is, all loan restructurings and modifications that meet key sustainability criteria—whether a HAMP modification or not—should remain subject to the original risk weight assigned to the mortgage at origination. 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. The Associations welcome an opportunity to work with the Agencies to develop a set of criteria that promotes sustainable private modifications.

### 6. Recognize Private Mortgage Insurance

The Standardized Approach NPR does not recognize PMI at the individual or the pool-wide level "due to the varying degree of financial strength of mortgage providers."[39] The Agencies solicited comments on whether to recognize PMI for purposes of calculating the LTV ratio of a residential mortgage. In particular, the Agencies asked what criteria the Agencies could use to ensure that "only financially sound PMI providers are recognized."[40]

The Associations have serious concerns about the lack of PMI recognition and strongly support modifying the proposal to recognize PMI at the individual and the pool-wide level as an offset to loan value in calculating the LTV ratio. The proposed non-recognition of

[38] In fact, from a capital perspective, the proposal might provide incentives for a bank to foreclose on a loan, rather than to work it out with the borrower, in some circumstances.

[39] Standardized Approach NPR at 52,899.

[40] Standardized Approach NPR, Question 6.

PMI is a significant departure from residential mortgage rules under the current general risk-based capital requirements. This departure is unwarranted because, like other guarantees, PMI is a credit mitigant that plainly reduces the risk of loss of the underlying mortgage. Moreover, PMI providers are regulated by state insurance departments, which set capital and reserve requirements, oversee credit and operational risk, and regulate product pricing and guidelines.

Nonetheless, the Associations recognize that some PMI providers may be less financially sound than others and that PMI issued by less financially sound providers may result in less effective credit loss mitigation than PMI issued by providers that are more financially sound. Accordingly, the Associations believe that sound prudential standards can be developed to define Qualified PMI ("**QPMI**") providers, which would qualify for recognition of the credit risk mitigation benefit of PMI. Such prudential standards should reflect that the risks associated with writing PMI differ from those of banking or providing other forms of credit guarantees and merit an appropriate methodology to determine financial soundness for the purpose of capital recognition. Alternatively, the Associations recommend recognizing "investment-grade" PMI providers using an approach similar to the OCC's investment securities guidance.

**a. Recognize Qualified Private Mortgage Insurance Providers**

One way to distinguish financially sound PMI providers is to adopt standards that would require a QPMI provider to hold sufficient capital and reserves to pay claims under conditions of prolonged economic stress that would result in substantial mortgage losses. The Associations propose the development of a single model to determine PMI providers' ability to pay claims during periods of economic stress, based on the PMI industry's aggregate data during the most recent financial crisis, and then apply this model to each provider's book of business. By applying one model to all PMI providers, banking organizations and regulators would be able to evaluate all providers by a single standard. A single model based on aggregate PMI industry data would also be more reliable because it would be based on a broad range of data.

This model of a PMI provider's ability to pay claims should:

- Be based on at least five years of data to account for a prolonged period of economic stress;
- Evaluate PMI providers on a "run off" basis that does not rely on premiums from future customers to pay for claims on a provider's existing book; and

- Calculate future losses and claims obligations based on the actual risk of the underlying mortgages in a manner that also accounts for differences in loan features and borrower credit quality.

Once a specific model is chosen, a PMI provider would calculate the amount of capital required to pay claims during periods of economic stress. This amount would be the provider's minimum capital requirement. A PMI provider should refresh its minimum capital calculation on a regular basis to reflect changes in the risk characteristics, capital and reserves of the provider.

After a PMI provider determines its minimum capital requirement, it would calculate its ratio of actual capital to required capital to determine whether it qualifies as a QPMI provider. Banking organizations would be permitted to recognize the risk mitigation benefits of PMI from a provider that meets or exceeds its minimum capital requirement—also known as a QPMI provider. In addition, the Associations propose a buffer zone over and above the minimum capital requirement as a conservative "early warning" of any potential deterioration of a QPMI provider's ability to pay claims. This on-going assessment of a QPMI provider's capital adequacy would identify the weakening financial condition of a provider on a timely basis.

Such an approach would allow banking organizations to recognize appropriate relative levels of loss mitigation associated with PMI providers that have different risk profiles and to adjust such recognition on a regular and timely basis. It would also allow banking organizations and QPMI providers to identify potential issues in the QPMI providers' financial condition and to correct these issues accordingly.

The Associations welcome an opportunity to work with the Agencies to establish a set of sound prudential standards for PMI providers and to develop a methodology for appropriately recognizing the credit risk mitigation benefits from financially sound PMI providers. The Associations strongly believe that such an approach reflects the actual risk of mortgage exposures far better than the approach in the Standardized Approach NPR, which fails to recognize *any* benefit of PMI loss mitigation and is therefore plainly at odds with the actual mitigation that mortgage insurance can and often does provide.

**b. Recognize "Investment Grade" PMI Providers**

Another way to distinguish financially sound PMI providers is to adopt an approach similar to the one taken in the OCC's investment securities guidance. Under such an approach, banking organizations would be allowed to fully recognize PMI only if the PMI provider was considered "investment-grade." An investment-grade PMI provider would be one that has "adequate capacity to meet financial commitments under the [mortgage] for the projected life of the asset or exposure."[41] To determine whether a PMI provider has adequate capacity to meet financial commitments under the mortgage, a banking organization would need to determine that (i) the risk of default by the PMI provider is low; and (ii) the full and timely payment of the insured amount is expected should the mortgage default.[42] Banking organizations may use a variety of factors, including external credit ratings and assessments, to make this risk determination. However, a banking organization may not rely exclusively on external credit ratings; it must also supplement external ratings "with a degree of due diligence processes and additional analyses that are appropriate for the bank's risk profile and for the size and complexity of the [asset]."[43]

Even under this approach, the methodology discussed above could serve as a valuable tool to determine if a PMI is investment grade. If a banking organization determines that a PMI provider is investment-grade, then it should be allowed to fully recognize the PMI for offset purposes. If a banking organization is unable to determine that a PMI provider is investment-grade, then the banking organization would recognize a lesser percentage of the PMI. The Associations believe that this approach would also strike an appropriate balance between recognizing PMI as an important risk mitigant while acknowledging that some PMI providers are more financially sound than others.

### 7. Maintain Safe Harbor for Credit-Enhancing Representations and Warranties

Under the existing general risk-based capital framework, risk-based capital charges do not apply to residential mortgages once they are sold to third parties, including where the seller provides representations and warranties to take back mortgages that experience very early payment defaults (*i.e.*, within 120 days of the sale of the mortgages) or that permit the return of assets in instances of fraud, misrepresentation or incomplete documentation. The Standardized Approach NPR would fundamentally change this framework by assigning new risk weights to certain off-balance sheet risks, including risks arising from certain credit-enhancing representations and warranties for "pipeline" mortgages.

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[41] *See* OCC, *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 77 Fed. Reg. 35,253, 35,257 (June 13, 2012) (revising 12 C.F.R. § 1.2(d)).

[42] *See* 12 C.F.R. § 1.2(d).

[43] *See* OCC, *Alternatives to the Use of External Credit Ratings in the Regulations of the OCC*, 77 Fed. Reg. 35,253, 35,254 (June 13, 2012).

### a. Early Payment Defaults

The proposal would change the current framework by treating representations and warranties for early payment defaults as off-balance sheet assets with a 100 percent CCF applying to the value of the loans that are sold. The proposed rule expressly seeks comment on this fundamental change in the treatment of such representations and warranties.[44]

The Associations strongly disagree with the proposed approach, which would result in substantial additional capital charges for a significant volume of sold mortgages. There is little evidence to support this worst-case approach because the temporary representations and warranties associated with such pipeline mortgages have rarely resulted in significant losses for regulated banking organizations.

Moreover, the proposal would have a large impact on a broad range of banking organizations because it affects banking organizations of all sizes that sell mortgages to GSEs.[45] In fact, the proposal could double the risk-weighted assets for certain banking organizations with large volumes of these pipeline mortgages and cause their capital ratios to fall by five or more percentage points. A number of community banks have indicated that they may need to stop making residential mortgage loans simply because such mortgages would become too expensive to originate and sell, despite the low risk associated with this activity.

Finally, the proposed treatment of credit-enhancing representations and warranties would double-count the capital requirement for mortgages protected by these representations and warranties that are held after purchase by other lenders. The institution purchasing the mortgages must account for the mortgages in its risk-weighted assets, and the institution guaranteeing the loans also must account for the guarantee in its risk-weighted assets. This double-counting of the same asset is both unduly conservative and exceptionally burdensome.

The Associations thus urge the Agencies to remove the capital charge for credit-enhancing representations and warranties and to maintain the safe harbor in the current risk-based capital requirements for early default clauses. The Agencies should study the actual loss experience of regulated banking organizations with such early default provisions, which the Associations believe will not have been significant, and to calibrate any capital charge or CCF to the observed risk.

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[44] Standardized Approach NPR, Question 10.

[45] *See* Freddie Mac, Bulletin 2012-18, at 6 (Sept. 11, 2012) (requiring repurchase for early default mortgages); Fannie Mae, Selling Guide Announcement SEL-2012-08, at 7 (Sept. 11, 2012) (same).

### b. Fraud and Misrepresentations

The Associations also strongly urge the Agencies to make clear in any re-proposal of the Standardized Approach NPR, that warranties which permit the return of assets in instances of fraud, misrepresentation or incomplete documentation are not subject to risk-based capital charges. The definition of "credit-enhancing representations and warranties" states that it does "not include warranties that permit the return of underlying exposures in instances of misrepresentation, fraud, or incomplete documentation."[46] However, the preamble to the Standardized Approach NPR is unclear and could be read to suggest that warranties for fraud, misrepresentation and incomplete documentation would be subject to the 100 percent CCF and accompanying capital charge.[47]

Any potential argument that warranties for fraud, misrepresentation or incomplete documentation are subject to capital charges would have a dramatic, detrimental impact on banking organizations' capital ratios because such warranties are held for the entire life of the loan. For at least some small and regional banks, this approach would cause risk-weighted assets to balloon by 500 percent and capital ratios to drop by more than 10 percent. The Associations therefore believe it is critical for the Agencies to make clear in any re-proposal of the Standardized Approach NPR that such warranties are not subject to capital charges.

## V. High Volatility Commercial Real Estate

The Standardized Approach NPR assigns a new, 150 percent risk weight to high volatility commercial real estate ("**HVCRE**"). HVCRE is defined as "a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property" and excludes one- to four-family residential properties as well as certain CRE projects with low LTV ratios and borrower investment.[48]

The proposed treatment of HVCRE, as modified by its exclusions, appropriately recognizes that different types of CRE lending present different types and levels of risk. But this recognition of risk differentiation does not go far enough. In particular, the proposed rule should also:

- Clarify that the definition of HVCRE does not include completed, income-earning loans;
- Clarify that the definition of HVCRE does not include agricultural loans;

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[46] Basel III Numerator NPR § ___.2 (Definitions).

[47] Standardized Approach NPR at 52,902.

[48] Basel III Numerator NPR § ___.2 (Definitions).

- Exclude properties that meet a debt service coverage ratio ("**DSCR**") of 1.1 from the definition of HVCRE;
- Exclude owner-occupied CRE loans from the definition of HVCRE;
- Exclude small-dollar CRE loans from the definition of HVCRE;
- Exclude affordable housing projects financed by low income housing tax credits from the definition of HVCRE;
- Recognize "other acceptable collateral" as capital contributed by borrowers for purposes of the exclusion from HVCRE;
- Calculate contributed capital percentage based on estimated costs; and
- Include additional risk sensitivity within the HVCRE risk weight according to the LTV ratio.

Together, these changes would align the risk weights of CRE assets with their actual risk and better reflect banking organizations' actual underwriting practices. Because the definition of HVCRE is common to both the Standardized Approach NPR and the Advanced Approaches NPR, the Associations' comments apply to both NPRs.

**A. Clarify Definition of HVCRE**

The proposal defines HVCRE as "a credit facility that finances *or has financed* the acquisition, development, or construction (ADC) of real property."[19] This definition could be read to encompass ADC loans through the entire life of the loans, including after the property has been completed and tenants occupy the building. However, it is the Associations' understanding that the definition was not intended to exclude completed, income-earning properties.

Accordingly, due to the potentially broad scope of the proposed definition of HVCRE, the Associations request that any re-proposal of the Standardized Approach NPR make clear that HVCRE does not include completed, income-earning properties. The Associations believe that this limited definition of HVCRE is consistent with the actual risk profile of ADC property: Although ADC loan exposures present unique risks during the development and construction stages, these risks plainly decrease once the underlying property has been completed and is ready for tenant use. At that point, expenditures shift from construction costs to tenant improvements and building operations, and risk substantially decreases as it

[19] Basel III Numerator NPR § ___.2 (Definitions) (emphasis added).

shifts from development risk to cash-flow risk. Therefore, banking organizations should be permitted to reevaluate ADC loans after the underlying property has been completed and treat such loans as general corporate exposures, like other CRE loans, rather than higher risk-weighted HVCRE exposures.

### B. Exclude Properties that Meet Certain Debt Service Coverage Ratios from HVCRE Definition

The Standardized Approach NPR would assign a 150 percent risk weight to all HVCRE, regardless of the risk characteristics of the borrower. This approach is inconsistent with industry practice and does not accurately reflect the actual risk of the transaction. Moreover, the high risk weight associated with HVCRE raises the costs of borrowing for all HVCRE borrowers, even those with low risk characteristics.

To account for the lower risks associated with certain borrowers, the Associations request the exclusion of ADC property from the definition of HVCRE for a borrower that has a DSCR of at least 1.1. A DSCR of 1.1 or greater indicates that the borrower has sufficient cash flow to meet annual principal and interest payments and thus presents a lower risk of default than other HVCRE borrowers. CRE loans to such low-risk borrowers instead should be risk-weighted as a general CRE or corporate loan at 100 percent. This lower risk weight appropriately reflects the actual risk of such a loan and would also prevent unnecessary increases in the cost of borrowing for such borrowers.

### C. Exclude Owner-Occupied Properties from HVCRE Definition

Any re-proposal of the Standardized Approach NPR should also exclude owner-occupied CRE from the definition of HVCRE. Most owner-occupied CRE loans are made to businesses that occupy the underlying property to operate their business. The riskiness of such loans depends primarily and fundamentally on the success of the business, not on the development and construction of the property. Consistent with this risk profile, banking organizations underwrite owner-occupied CRE loans in a manner similar to corporate loans. Such loans should therefore be excluded from the definition of HVCRE and instead treated the same as general CRE and corporate loans with a 100 percent risk weight.

### D. Exclude Small-Dollar CRE from HVCRE Definition

Any re-proposal of the Standardized Approach NPR also should exclude CRE with a loan amount of less than $1 million from the definition of HVCRE. Small-dollar CRE loans typically are made to small business owners that occupy the ADC property and that typically have higher credit quality and a lower risk of default than other HVCRE borrowers. Moreover, similar to owner-occupied CRE, the riskiness of small-dollar CRE loans depends primarily on the success of the borrower's business rather than on the development and construction of the property. Therefore, like owner-occupied CRE, small-dollar CRE loans also should be excluded from the definition of HVCRE and instead treated as general CRE and corporate loans with a 100 percent risk weight.

### E. Exclude Affordable Housing Projects Financed by Low Income Housing Tax Credits from HVCRE Definition

The Low Income Housing Tax Credit ("**LIHTC**") Program is an indirect federal subsidy used to finance the development of affordable rental housing for low-income households. Other federal statutes, such as the CRA, encourage the use of the LIHTC Program. However, the proposed HVCRE rules discourage the use of LIHTC or, at the very least, increase the cost of such projects.

LIHTC awards require that property owners accept and maintain ongoing restrictions on tenant rental rates. Those rental restrictions reduce projected net operating incomes and therefore reduce the appraised values of those projects. Lower appraised values increase LTV ratios and drive a higher percentage of these projects into the proposed HVCRE category. Because of the significant downward pressure on rents (and therefore property values) caused by the rental rate restrictions, loans with even moderate loan-to-cost ratios could generate LTV ratios exceeding the proposed HVCRE thresholds. Additionally, the capitalization of these projects often includes "soft pay" subordinated debt from public sector sources (*i.e.*, debt repayable only to the extent of excess cash flow, if any) or donated land from public sector sources—neither of which complies with the definition of up-front equity for purposes of the proposed 15 percent test in clause (2)(ii) of the exclusion from HVCRE.

At the same time, these projects pose little market risk, and historic performance patterns have not been "volatile." The same downward pressure on rent and property values makes such properties attractive for renters. Additionally, many LIHTC projects have pre-committed, permanent takeout financing committed up-front to mitigate repayment risk.

In light of these characteristics, the Associations request that any definition of HVCRE explicitly exclude credit facilities for projects financed by LIHTC or, more generally, limited by ongoing rent restrictions. A 100 percent risk weight is more appropriate given the policy objectives in favor of LIHTC projects and the low-risk profile of such projects. This change would also be consistent with the proposed treatment of community development equity exposures at a 100 percent risk weight.[50]

[50] *See* Standardized Approach NPR at 52, 966, § __52(b)(3)(i).

### F. Recognize "Other Acceptable Collateral" as Capital Contributed By Borrower

The proposed Standardized Approach NPR excludes ADC projects from the definition of HVCRE if "(2) . . . (i) the loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio in the [AGENCY]'s real estate lending standards . . . ; (ii) the borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised 'as completed' value; and (iii) the borrower contributed the amount of capital required in (2)(ii) of this definition before the [banking organization] advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project"—that is, until the facility is converted to permanent financing or is sold or paid in full.[51]

The requirement in clause (2)(ii) that a borrower must contribute cash or unencumbered readily marketable assets is too narrow. In practice, commercial borrowers contribute to an ADC project in a variety of ways that reduce the risk of the loan. For example, some borrowers provide land rather than cash for an ADC project. Such loans are less risky due to the borrower's investment in the property, yet the proposal would nonetheless risk weight these loans at 150 percent. Similarly, the proposed rule does not recognize irrevocable standby letters of credit for the benefit of the lender, even though such letters guarantee payment for the lender. Moreover, clause (2)(i) of the exclusion references the Agencies' real estate lending standards, which allows both readily marketable collateral and "other acceptable collateral" securing the extension of credit to be included as collateral in the LTV ratio, to determine the appropriate LTV ratio, yet clause (2)(ii) does not recognize such sources of collateral.

The Associations therefore request that any re-proposal of the Standardized Approach NPR recognize "other acceptable collateral" as defined in the Agencies' real estate lending standards as capital contributed by the borrower for purposes of clause (2)(ii) of the exclusion from HVCRE. This approach would be consistent with the reference to the real estate lending standards in clause (2)(i) of the definition and with banking organizations' actual underwriting practices. As specified in the real estate lending standards, other acceptable collateral should be appropriately discounted consistent with the lender's practices for making loans secured by such collateral.

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[51] Basel III Numerator NPR § ___.2 (Definitions).

### G. Calculate Borrower-Contributed Capital Percentage Based on Estimated Costs

As described above, the proposed definition of HVCRE excludes loans in which the borrower has contributed capital to the project "of at least 15 percent of the real estate's appraised 'as completed' value."[52] This proposed definition would be difficult to implement because the "as completed" value could not be appraised until the project is completed. The Associations request that, in any re-proposal of the Standardized Approach NPR, the Agencies instead establish an "estimated costs" standard, which would replace the phrase "the real estate's appraised 'as completed' value" in clause (2)(ii) of the HVCRE definition to read "the estimated total development costs through completion of construction and stabilization as approved by the lender." Using an "estimated costs" standard is both more conservative and more practical to implement.

### H. Tier HVCRE Risk Weights According to LTV Ratio

The proposal applies the same 150 percent risk weight to all HVCRE loans, regardless of the LTV ratio. The Associations believe that this approach fails to recognize the variety of risks in HVCRE exposures: Just as residential mortgage loans present different risks depending on LTV ratio, so too do CRE loans. The Associations thus recommend that any re-proposal of the Standardized Approach NPR include additional risk sensitivity within the HVCRE bucket by assigning risk weight tiers according to the LTV ratio.

## VI. Exposures to Securities Firms

The Standardized Approach NPR would treat exposures to all securities firms as corporate exposures with a 100 percent risk weight.[53] This approach is inconsistent with International Basel II and is inconsistent with the actual risk profile of such exposures.

International Basel II provides that "[c]laims on securities firms may be treated as claims on banks provided these firms are subject to supervisory and regulatory arrangements comparable to those under this Framework (including, in particular, risk-based capital requirements)."[54] The proposed departure from International Basel II will place the U.S. banking sector at a significant competitive disadvantage internationally.

Moreover, the proposed treatment of exposures to securities firms does not accurately reflect the actual risk of such exposures and is inconsistent with the relative risk of such

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[52] Basel III Numerator NPR § ___.2 (Definitions).

[53] *See* Standardized Approach NPR at 52,897.

[54] International Basel II at ¶ 65.

exposures. The Standardized Approach NPR applies a 100 percent risk weight to general corporate exposures. However, securities firms are more regulated than general corporations and are subject to general supervision and a variety of capital requirements that improve the credit quality of such firms. The risk weight applicable to such securities firms thus should be lower than 100 percent.

The Associations thus request the adoption of a regulatory capital approach that is consistent with International Basel II and more accurately reflects the actual and relative risk of exposures to securities firms. Under such an approach, exposures to securities firms that comply with comparable regulatory and supervisory regimes as U.S. banks—recognizing the differences in the securities firm model—would receive the same 20 percent risk weight as exposures to U.S. banks. If the counterparty or obligor is deemed not to meet comparable regulatory standards, then such claims would be risk-weighted as corporate exposures consistent with the risk-based treatment under the International Basel II framework.

The comparability determination should account for differences in regulatory regimes across jurisdictions. In particular, exposures to securities firms in jurisdictions where securities firms and banks are already subject to a common regulatory framework should be subject to a 20 percent risk weight. For example, in the EU, the Capital Requirements Directive ("**CRD**") establishes uniform requirements on capital measurement and capital standards for EU financial institutions (including banks and securities firms alike) under the international Basel capital framework.[55]

Likewise, in the United States, the Securities and Exchange Commission ("**SEC**") approves certain broker-dealers to apply the "alternative net capital" regulatory capital approach. This alternative method permits a broker-dealer to use approved mathematical models to calculate net capital requirements for market and derivatives-related credit risk in a manner comparable to International Basel II and requires supervisory and regulatory oversight comparable to that applicable to U.S. banking organizations.

In addition, the Dodd-Frank Act contains a number of statutory provisions that are intended to subject financial institutions (including banks and securities firms) to enhanced and comparable regulation. For example, the Dodd-Frank Act provides that the Agencies, certain other prudential regulators, the SEC and the Commodity Futures Trading Commission

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[55] *See* Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the Capital Adequacy of Investment Firms and Credit Institution, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2006:177:0201:0255:EN:PDF. *See also* CRD IV Regulation (July 20, 2011), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0452:FIN:en:PDF

("**CFTC**") "shall, to the maximum extent practicable, establish and maintain comparable minimum capital requirements" for participants in the swaps market.[56]

Therefore, the Associations believe that an evaluation of the comparability of regulatory capital regimes of securities firms to determine the applicability of the 20 percent risk weight is a prudent, risk-based approach that is consistent with International Basel II. Such treatment would more accurately reflect the risk of such exposures and would avoid placing banking organizations that are subject to U.S. capital requirements at a global disadvantage.

At the very least, exposures to U.S. bank-affiliated securities firms should be subject to the same 20 percent risk weight as exposures to U.S. banks. Bank-affiliated securities firms are subject to consolidated supervision and capital requirements of U.S. banking regulators and therefore should be treated like U.S. banks for purposes of the risk-weighting of exposures to such firms.

## VII. Past Due Exposures

The Standardized Approach NPR assigns a 150 percent risk weight to an exposure that is 90 days or more past due or on nonaccrual (and that is not guaranteed, not secured, not a sovereign exposure and not a residential mortgage exposure). This treatment is fundamentally inappropriate because it ignores (i) the independent requirement to increase loss reserves for past due loans; and (ii) the required *full deduction* from capital for certain of those increased loss reserves.

Banking organizations increase loan loss reserves when loans become delinquent, independent of risk-based capital standards, and external auditors and agency examiners carefully review such increased provisioning to ensure that loan loss reserves are adequate. Such increases in reserves effectively increase the loss-absorption capacity of the banking organization in the same way as increased capital. Thus, requiring higher risk weights for past due loans, which at the margin would result in higher capital for such loans, effectively results in a kind of double-counting of the increased loss-absorption capacity already resulting from provisions to loan loss reserves for the very same loans. Moreover, loan loss reserves exceeding 1.25 percent of standardized assets are separately required to be *deducted* from Tier 2 capital. In such circumstances, requiring higher risk weights for delinquent loans while at the same time deducting from capital the provisions associated with such loans would result in an even greater degree of double-counting.

[56] Dodd-Frank Act § 731.

In this context, further increasing the risk weight for past due exposures—in addition to increasing associated reserves and the potential capital deduction for such reserves—double-counts the risk of default for delinquent loans. This double-counting amplifies the pro-cyclicality of the banking industry by requiring more capital and accelerating the contraction of credit during times when credit is needed the most.

## VIII. OTC Derivatives

The Standardized Approach NPR would largely retain the same treatment of OTC derivatives as is provided under the existing generally applicable risk-based capital rules. This approach is similar to the current exposure method ("**CEM**") first introduced in 1988—nearly a quarter of a century ago—as part of the original Basel capital accord. The Associations have a number of concerns with the proposed CEM and therefore request the Agencies to permit the internal models methodology ("**IMM**") as an alternative in any re-proposal of the Standardized Approach NPR, consistent with the international Basel capital framework. Further, any re-proposal should provide greater recognition to netting benefits and apply a 15 percent haircut to exposure amounts calculated under the CEM for any banking organization that does not receive supervisory approval to calculate its exposure amounts using the IMM. Finally, the Associations strongly believe that any re-proposal of the Standardized Approach NPR should continue to allow any banking organization that does not use the IMM as a permitted alternative to the CEM (as recommended above) to apply the 50 percent risk weight ceiling for exposures to OTC derivative contracts.

### A. Limitations of CEM

Under the proposed CEM, the exposure amount for an OTC derivative contract is equal to the sum of the banking organization's current credit exposure and potential future exposure ("**PFE**") on the derivative contract. Although the Agencies have made some adjustments to the CEM, it remains a rudimentary, one-dimensional method that lacks the risk sensitivity necessary to calculate credit exposure from OTC derivatives.

First, the PFE formula significantly limits the degree to which netting benefits are taken into account. The PFE incorporates a gross approach, which does not recognize offsetting positions that reduce actual counterparty credit risk, rather than a net approach. Thus, for example, two trades that exactly offset risk exposures and create no counterparty risk will be deemed to generate potentially significant counterparty credit exposure under the CEM.

Second, the CEM does not fully recognize mitigants that banking organizations employ to manage and reduce counterparty risk. Contrary to industry practice, the PFE assumes that a portfolio will remain uncollateralized through the final maturity date of each contract in the portfolio. In practice, however, collateral is posted against exposures in the form of variation margin on a daily basis. Because positions typically are marked to market at least daily, variation margin generally covers exposures through the close of the last business day before default. Thus, exposure is limited to any changes in market value that occur between the last margin payment and the time the derivative contract is closed-out or replaced following counterparty default. If a counterparty fails to comply with the terms of the contract, *e.g.*, by failing to post collateral, a banking organization would declare default and the trades would be closed out and settled on a net basis. Daily collection of variation margin significantly reduces the risk of a portfolio and is at the core of prudent risk-management practices.

Banking organizations also consider the potential for a change in mark-to-market value during the period after a counterparty's insolvency but before liquidation of any non-cash collateral. Banking organizations mitigate the additional exposure that arises during this period by applying haircuts to the value of non-cash collateral and potentially also by collecting initial margin—both of which are valuable risk-reduction tools that are not recognized in the PFE formula.

Third, the Standardized Approach NPR would calculate the CEM for each individual position rather than for the portfolio in the aggregate. This approach overlooks the risk-reducing effects of portfolio diversification and overstates the exposure amount. This overstatement is particularly large in the context of portfolios with a large number of positions and low net risk—precisely the type of portfolio held by most banking organizations. For instance, a recent study found that CEM understated the benefits of diversification in interest rate portfolios by a factor of approximately 2.5.[57]

**B. Alternatives to CEM**

Due to the lack of recognition of netting benefits, risk mitigants and portfolio diversification, as well as the limits of extrapolation, the CEM substantially overstates the exposure amount of OTC derivatives. Given all of these well-known problems with the CEM, any re-proposal of the Standardized Approach NPR should allow banking organizations to use the IMM as an alternative to the CEM. Furthermore, to compensate for the overstatement in exposure amount inherent in the CEM approach for banking organizations that do not receive regulatory approval for the IMM, the CEM should be revised to allow greater netting of PFE and to apply a 15 percent haircut to the CEM calculation.

[57] *See* International Swaps and Derivatives Association, *A Note on the Impossibility of Correctly Calibrating the Current Exposure Method for Large OTC Derivatives Portfolios* (June 2011), *available at* http://www2.isda.org/attachment/MzIwMA==/CEM%20vs%20EPE%20Research%20Note%20final.pdf.

### 1. Allow Use of the Internal Models Methodology

The Agencies specifically requested comments on whether to include the IMM for calculating exposure amounts for OTC derivatives, eligible margin loans, repo-style transactions and cleared transactions for all banking organizations.[58] The Associations strongly support permitting the IMM as an alternative given the many shortcomings of the CEM. The Associations further request that the standard for regulatory approval of each institution's model should be commensurate with that institution's size and complexity.

Although the Associations recognize the Agencies' concerns regarding the potential limitations of model-based approaches, the IMM is far more accurate than the CEM in measuring risk. In addition, any concerns the Agencies may have regarding IMMs should be mitigated by continual and horizontal reviews of each bank's IMM by the appropriate federal banking supervisor.

The Associations note that under the international Basel capital framework, banking organizations using the standardized approach are permitted to use the IMM if they receive supervisory approval. Permitting the use of the IMM in any re-proposal of the Standardized Approach NPR would therefore align the U.S. regulatory capital framework with international capital standards.[59]

### 2. Allow Greater Netting of PFE

The PFE formula should also be improved for those banking organizations that do not receive supervisory approval for their IMM. As described above, the CEM results in an overstated exposure amount in part because the proposed PFE formula significantly limits netting. Recognizing the benefits of netting, the Basel Committee recently revised the PFE formula to allow 85 percent netting of the PFE.[60] In contrast, the Standardized Approach

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[58] Standardized Approach NPR, Question 15.

[59] International Basel II, Annex 4 ¶ 20 ("The internal modelling method [IMM] is available both for banks that adopt the internal ratings-based approach to credit risk and for banks for which the standardised approach to credit risk applies to all of their credit risk exposures."). International Basel III did not modify paragraph 20 of Annex 4 of International Basel II. *See also* CRD IV Regulation, Chapter 6 (Counterparty Credit Risk). Art. 268(1) ("Where permitted by the competent authorities in accordance with paragraphs 1 and 2 of Article 277, an institution may determine the exposure value for the following items using the Internal Model Method set out in Section 6: (a) the contracts listed in Annex II; (b) repurchase transactions; (c) securities or commodities lending or borrowing transactions; (d) margin lending transactions; (e) long settlement transactions.").

[60] *See* Basel Committee, *Capital Requirements for Bank Exposures to Central Counterparties*, 8 (July 2012), *available at* http://www.bis.org/publ/bcbs227.pdf.

NPR would allow just 60 percent.[61] The Associations thus request that any re-proposal of the Standardized Approach NPR, at the very least, recognize 85 percent netting of PFE to be consistent with the international Basel capital framework and to better reflect actual exposure amount.

### 3. Impose 15 Percent Haircut for CEM

Allowing greater netting of PFE would correct for some overstatement of exposure amount in the CEM, but it would not address the CEM's lack of recognition of risk mitigants and of portfolio diversification, as discussed above. Thus, if a banking organization does not receive supervisory approval for its IMM, then any re-proposal of the Standardized Approach NPR should allow the banking organization to apply a 15 percent haircut to the exposure amount calculated using the CEM to compensate for the significant overstatement of exposure amount.

Even a 15 percent haircut, however, should be viewed as only a temporary measure until the Basel Committee enhances the CEM to be more risk-sensitive. To that end, the Associations request the Agencies to continue to work with the Basel Committee to improve the CEM.

## C. Maintain 50 Percent Risk Weight Ceiling

Under the general risk-based capital rules, the risk weight applied to an OTC derivative contract is limited to 50 percent. The proposal removes this risk weight ceiling, reasoning that "the types of counterparties acceptable to participants have expanded to include counterparties that merit a risk weight greater than 50 percent."[62] The Agencies specifically solicit comment on the removal of the risk weight cap.[63]

The Associations strongly oppose the removal of the risk weight cap. As discussed above, the CEM is not a risk-sensitive measure and significantly overstates banking organizations' exposure to OTC derivatives. Consequently, any banking organization that does not use the IMM as a permitted alternative to the CEM (as recommended above) should be allowed to continue to apply a 50 percent risk weight ceiling.

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[61] *Compare* Basel Committee, *Capital Requirements for Bank Exposures to Central Counterparties* at 8 ($A_{net} = 0.15 \times A_{gross} + \mathbf{0.85} \times NGR \times A_{gross}$) *with* Standardized Approach NPR § ___.34(a)(2)(ii) ($A_{net} = 0.4 \times A_{gross} + \mathbf{0.6} \times NGR \times A_{gross}$).

[62] Standardized Approach NPR at 52,904.

[63] Standardized Approach NPR, Question 11.

## IX. Cleared Transactions

The provisions governing the capital treatment of cleared transactions and exposures to the default funds of central counterparties ("**CCPs**") in the Standardized Approach NPR are substantively identical to those in the Advanced Approaches NPR. Accordingly, the Associations' comments and recommendations below apply to both NPRs.

In July 2012, the Basel Committee published an interim framework regarding capital requirements for bank exposures to CCPs.[64] The interim framework makes a number of revisions to the Basel Committee's November 2011 consultative document:

(i) It provides clearing member banking organizations *some* capital relief with respect to their exposures to clearing member clients by recognizing the shorter close-out period for cleared transactions and allowing clearing members to apply a margin period of risk of at least five days (if they adopt the IMM) or to multiply the exposure at default ("**EAD**") by a scalar of no less than 0.71 (if they are using the CEM)—although clearing member exposures to clients are still categorized as bilateral trades for regulatory capital purposes;

(ii) With respect to the capital charge for a clearing member banking organization's default fund exposures to qualifying CCPs ("**QCCPs**"), the interim framework adjusts the CEM formula used to calculate the hypothetical capital of the QCCP to give greater weight to the net-to-gross ratio and thereby recognizes the benefits of netting to a slightly greater extent—although QCCPs are still not permitted to use more risk-sensitive internal models to calculate their hypothetical capital requirement;

(iii) With respect to the capital charge for default fund exposures to QCCPs, the interim framework allows a clearing member banking organization to use an alternative, simplified method (referred to in the interim framework as "**Method 2**") under which default fund exposures will be subject to a 1,250 percent risk weight, subject to an overall cap on the risk-weighted assets from all its exposures to the QCCP (*i.e.*, both trade exposures and default fund exposures) equaling 20 percent times the banking organization's trade exposures to the QCCP; and

(iv) The interim framework clarifies that "Where a bank acts as a clearing member of a CCP for its own purposes, a risk weight of 2% must be

[64] *See* Basel Committee, *Capital Requirements for Bank Exposures to Central Counterparties* (July 2012), *available at* http://www.bis.org/publ/bcbs227.pdf.

> applied to the bank's trade exposure to the CCP in respect of OTC derivatives, exchange traded derivative transactions and SFTs. Where the clearing member offers clearing services to clients, the 2% risk weight also applies to the clearing member's trade exposure to the CCP that arises when the clearing member is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults."[65]

The Associations believe that the interim framework's revisions to the November 2011 consultative document generally represent a step in the right direction insofar as the limited capital relief for exposures to clearing member clients is recognition that the capital framework for cleared transactions should create incentives for clearing member banking organizations to clear client trades. Likewise, the adjustment to the CEM formula appears to recognize the need for a more risk-sensitive approach to the capitalization of a clearing member banking organization's default fund exposures to QCCPs. The Associations therefore believe that the Agencies should, at a minimum, incorporate the interim framework's revisions in their proposed treatment of transactions cleared through CCPs.

However, as the Basel Committee itself acknowledged when it promulgated the interim framework, "additional work is needed to develop an improved capital framework [for cleared transactions]."[66] In view of the significant role that U.S. banking organizations play in the domestic and international derivatives markets, both as clearing members and clearing member clients, the Associations encourage the Agencies to continue to actively participate in the Basel Committee's ongoing efforts to address the capitalization of banking organization exposures to CCPs.

Below, the Associations make a number of recommendations regarding the Agencies' proposals on the treatment of cleared transactions. Some recommendations relate to the way in which the Agencies propose to implement the Basel Committee's framework in the U.S.

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[65] *Id.* at 3. *Compare* Basel Committee, *Consultative Document: Capitalisation of Bank Exposures to Central Counterparties,* 11 (Nov. 2011), *available at* http://www.bis.org/publ/bcbs206.pdf ("Where a bank acts as a clearing member of a CCP. either for its own purposes **or as a financial intermediary between a client and a CCP**. a risk weight of 2% must be applied to the clearing bank's trade exposure to the CCP in respect of OTC derivatives. exchange traded derivative transactions and SFTs. The 2% risk weight for trade exposures also applies where the clearing member guarantees that the client will not suffer any loss due to changes in the value of its transactions in the event that the CCP defaults." (emphasis added).).

In other words, the Basel Committee's July 2012 interim framework makes it clear that a banking organization's role solely as "a financial intermediary between a client and a CCP," in the absence of a guaranty of the CCP's obligations to the client. does not attract a trade exposure capital charge.

[66] Basel Committee, Press Release for *Capital Requirements for Bank Exposures to Central Counterparties* (July 25, 2012), *available at* http://www.bis.org/publ/bcbs227.htm.

regulatory context while others apply equally to the Basel Committee's interim framework. The Associations encourage the Agencies to share these recommendations with other members of the Basel Committee.

### A. Definition of QCCPs

Consistent with the Basel Committee's interim framework and earlier consultative documents, the proposed capital framework for cleared transactions distinguishes between transactions cleared through QCCPs and those cleared through non-QCCPs, with trade exposures to QCCPs generally receiving lower risk weights.

As proposed, a QCCP is a CCP that (i) is a designated financial market utility ("**FMU**") under Title VIII of the Dodd-Frank Act; (ii) if not located in the United States, is regulated and supervised in a manner equivalent to a designated FMU; or (iii) meets a set of qualitative criteria. Significantly, the third prong of the QCCP definition requires a *banking organization* seeking to treat an exposure as a trade or default fund exposure to a QCCP to demonstrate to the satisfaction of its primary federal supervisor that the CCP in question is, among other things, "in sound financial condition" and "meets or exceeds (1) the risk-management standards for central counterparties set forth in regulations established by the Board, the CFTC or the SEC under Title VII or Title VIII of the Dodd-Frank Act; or (2) if the central counterparty is not located in the United States, similar risk-management standards established under the law of its home country that are consistent with international standards for central counterparty risk management as established by the relevant standard-setting body of the Bank of International Settlements."[67]

Rather than requiring each individual banking organization to demonstrate that a particular CCP satisfies the qualitative criteria under the third prong of the proposed QCCP definition, the Agencies should coordinate with the CFTC, the SEC and the home country regulators of non-U.S. CCPs, as applicable, to develop a definitive list of QCCPs on which U.S. banking organizations could rely for regulatory capital purposes. This "top-down" approach to determining QCCP status would lead to much greater consistency and efficiency than the "bottom-up" approach proposed by the Agencies. Such an approach would also be consistent with the Basel Committee's interim framework and consultative documents, which contemplate QCCP determinations being made by national banking supervisors.[68]

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[67] Basel III Numerator NPR § ___.2 (Definitions).

[68] Basel Committee, *Capital Requirements for Bank Exposures to Central Counterparties* at 1 (July 2012) ("Where the CCP is in a jurisdiction that does not have a CCP regulator applying the Principles to the CCP, *then the banking supervisor may make the determination of whether the CCP meets this definition.*" (emphasis added)).

The Associations also believe that, in light of the heightened regulatory standards applicable to CCPs under Title VII of the Dodd-Frank Act,[69] the Agencies should determine that all CFTC-registered derivatives clearing organizations ("**DCOs**") and all SEC-registered security-based swap clearing agencies ("**SBSCAs**") are QCCPs, unless the CFTC or SEC expressly objects to such classification with respect to a particular CCP. QCCP determinations should similarly be made with respect to CCPs that the CFTC or SEC exempt from registration because they are deemed by the CFTC or SEC to be subject to "comparable, comprehensive supervision" by another regulator.[70]

### B. Capital Treatment of Clearing Member's Default Fund Exposures

Consistent with the Basel Committee's interim framework and consultative document, the Agencies propose a three-step process for a banking organization that is a clearing member of a QCCP to calculate the risk-weighted asset amount for its exposures to the

[69] To be registered and to maintain registration as a derivatives clearing organization, a CCP must comply with specified core principles and any requirements that the CFTC may impose by rule or regulation. *See* Commodity Exchange Act ("**CEA**") § 5b(c)(2)(A) (as amended by the Dodd-Frank Act § 725(c)). Similarly, to be registered and to maintain registration as a security-based swap clearing agency, a CCP must comply with regulatory standards established by the SEC. *See* Securities Exchange Act of 1934 ("**SEA**") §§ 17A(b) and (i).

The Dodd-Frank Act also revised existing core principles and added new core principles with which DCOs must comply. These core principles cover topics such as compliance, financial resources, participant and product eligibility, risk management, settlement procedures, treatment of funds, default rules and procedures, rule enforcement, system safeguards, reporting, recordkeeping, public information, information sharing, antitrust considerations, governance fitness standards, conflicts of interest, composition of governing boards and legal risk. *See* CEA § 5b(c)(2) as amended by the Dodd-Frank Act § 725(c). In October 2011, the CFTC promulgated final regulations for derivatives clearing organizations and stated that its regulations are consistent with international standards for CCPs. *See* CFTC, *Derivatives Clearing Organization General Provisions and Core Principles*, 76 Fed. Reg. 69,334 (Nov. 8, 2011).

In March 2011, the SEC proposed regulations for SBSCAs and stated that they are consistent with current international standards for CCPs. Among other things, the SEC's proposed regulations would require SBSCAs to (i) maintain certain standards with respect to risk management and operations; (ii) have adequate safeguards and procedures to protect the confidentiality of trading information; (iii) have procedures that identify and address conflicts of interest; (iv) require minimum governance standards for their boards of directors; (v) designate a chief compliance officer; and (vi) disseminate pricing and valuation information if they perform central counterparty services for security-based swaps. *See* SEC, *Clearing Agency Standards for Operation and Governance*, 76 Fed. Reg. 14,472 (Mar. 16, 2011).

[70] The Dodd-Frank Act amends CEA Section 5b(h) and SEA Section 17A(k) to provide: "The [CFTC/SEC] may exempt, conditionally or unconditionally, a [DCO/SBSCA] from registration under this section for the clearing of [swaps/security-based swaps] if the [CFTC/SEC] determines that the [DCO/ SBSCA] is subject to comparable, comprehensive supervision and regulation by the [CFTC/SEC] or the appropriate government authorities in the home country of the [DCO/SBSCA]. Such conditions may include, but are not limited to, requiring that the [DCO/SBSCA] be available for inspection by the Commission and make available all information requested by the Commission."

QCCP's default fund.[71] The first step is to calculate the QCCP's hypothetical capital requirement ($K_{CCP}$). $K_{CCP}$ is effectively the amount of capital that a QCCP would be required to hold if it were a banking organization. $K_{CCP}$ is calculated using the CEM for OTC derivatives, taking into account the risk-mitigating effects of collateral posted by and default fund contributions received from the QCCP's clearing members. The Agencies propose certain modifications to the CEM for purposes of calculating $K_{CCP}$, including slightly increasing a multiplier in the formula used to calculate the adjusted sum of the PFE arising from a netting set of derivative transactions.[72]

Notwithstanding attempts to adjust the CEM to the clearing context, fundamentally, the CEM remains a rudimentary method for estimating PFE arising from OTC derivative transactions that was introduced in the 1988 Basel capital accord nearly a quarter of a century ago.[73] The Associations are concerned that the CEM, which was not developed with central clearing in mind, lacks the risk-sensitivity and sophistication for calculating the hypothetical capital requirement for a QCCP. The Associations do not believe that the CEM is an appropriate methodology for more sophisticated organizations such as CCPs that have well-hedged portfolios and that effectively engage in riskless principal activities.

Since the CEM was first introduced, significant advances in mathematical modeling, computer science and financial theory, as well as the development and trading of derivative

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[71] As proposed, default fund contribution means the funds contributed or commitments made by a clearing member to a CCP's mutualized loss sharing arrangement. *See* Basel III Numerator NPR § ___.2 (Definitions).

[72] Specifically, the formula would be changed from "$A_{net} = (0.4 \times A_{gross}) + (\mathbf{0.6} \times NGR \times A_{gross})$" to "$A_{net} = (0.3 \times A_{gross}) + (\mathbf{0.7} \times NGR \times A_{gross})$." $A_{net}$ is the adjusted sum of the PFE amounts. $A_{gross}$ is the sum of the PFE amounts (determined using the conversion factor method under the CEM) for each individual OTC derivative contract subject to a qualifying master netting agreement, and NGR is the net to gross ratio, *i.e.*, the ratio of the net current credit exposure to the gross current credit exposure. Under the CEM, the exposure amount for a netting set of derivative transactions equals the sum of the net current credit exposure (the greater of zero or net sum of all positive and negative mark-to-market values) and the adjusted sum of the PFE. The Associations note that the Basel Committee's interim framework increases this multiplier to 0.85.

[73] For a single OTC derivative contract that is not subject to a qualifying master netting agreement, the CEM dictates that the exposure amount be the sum of (i) the banking organization's current credit exposure (which would be the greater of the mark-to-market value or zero) and (ii) PFE, which would generally be calculated by multiplying the notional principal amount of the OTC derivative contract by the appropriate conversion factor (ranging from 0.00 to 0.15, depending on the type of underlying and remaining maturity). For multiple OTC derivative contracts subject to a qualifying master netting agreement, the CEM dictates that the exposure amount be calculated by adding the net current credit exposure and the adjusted sum of the PFE amounts for all OTC derivative contracts subject to the qualifying master netting agreement. The net current credit exposure would be the greater of zero and the net sum of all positive and negative mark-to-market values of the individual OTC derivative contracts subject to the qualifying master netting agreement. The adjusted sum of the PFE amounts would, to a certain extent, take into account the effects of bilateral netting by incorporating the net to gross ratio, *i.e.*, the ratio of the net current credit exposure to the gross current credit exposure.

products, have given rise to much more sophisticated and accurate methodologies for calculating credit exposure arising from derivative transactions. For example, the IMM, which uses expected positive exposure ("**EPE**") and effective EPE[74] as its building blocks, was introduced in the 2006 International Basel II framework and is used today by the largest and most sophisticated U.S. and international banking organizations. Similarly, CCPs have developed (and regularly update) internal models for calculating initial margin requirements and default fund contributions that are more appropriate to the central clearing context than the CEM.[75] In fact, the Federal Reserve's risk-management standards for systemically important FMUs require a systemically important FMU that operates as a CCP to "use[ ] risk-based models and parameters to set margin requirements."[76] Similarly, the CFTC's final rule setting forth core principles for DCOs requires DCOs to "use models that generate initial margin requirements sufficient to cover the derivatives clearing organization's potential future exposures to clearing members."[77] The SEC's proposed standards for SBSCAs also require SBSCAs to "(i) use risk-based models and parameters to set margin requirements; and (ii) review the models and parameters at least monthly."[78]

The capital framework for cleared transactions should avoid using 20th-century solutions to address 21st-century challenges. The risk-management capabilities of a QCCP are more akin to those of an advanced approaches banking organization, while its risk profile is effectively that of a riskless principal. Accordingly, the Associations encourage the

[74] To address the concern that EPE may not capture risk arising from the replacement of existing short-term positions over the one-year horizon used for capital requirements (rollover risk) or may underestimate the exposures of eligible margin loans, repo-style transactions and OTC derivatives with short maturities, the International Basel II framework and the current advanced approaches rules use a netting set's effective EPE as the basis for calculating EAD for counterparty credit risk.

[75] In their recent consultative document on margin requirements for non-centrally cleared derivatives, the Basel Committee and the Board of the International Organization of Securities Commissions ("**IOSCO**") recognized the utility of internal models in calculating margin requirements for derivative transactions, stating that "[i]nternal or third-party quantitative models that assess these risks in a granular form can be useful for ensuring that the relevant initial margin amounts are calculated in an *appropriately risk-sensitive manner*" (emphasis added). The consultative document also noted that the "current practice among a number of large and active CCPs is to use internal quantitative models when determining initial margin amounts."

[76] *See* Federal Reserve Board, *Financial Market Utilities*, 77 Fed. Reg. 45,907, § 234.4(a)(17) (Aug. 2, 2012).

[77] *See* CFTC, *Derivatives Clearing Organization General Provisions and Core Principles*, § 39.13(g)(2)(ii) ("A derivatives clearing organization shall use models that generate initial margin requirements sufficient to cover the derivatives clearing organization's potential future exposures to clearing members based on price movements in the interval between the last collection of variation margin and the time within which the derivatives clearing organization estimates that it would be able to liquidate a defaulting clearing member's positions (liquidation time).").

[78] *See* SEC, *Clearing Agency Standards for Operation and Governance*, 76 Fed. Reg. 14,472, § 240.17Ad–22(b)(2) (Mar. 16, 2011).

Agencies to permit a QCCP's hypothetical capital requirement ($K_{CCP}$) to be calculated, with regulatory approval if necessary,[79] by means of internal models or other appropriate methodologies in lieu of the CEM (unless, of course, the QCCP itself uses the CEM for purposes of calculating its hypothetical capital requirement).

Should the Agencies decide to adopt the modified CEM approach (as further adjusted by the Basel Committee's interim framework) in the interim, the Associations encourage the Agencies to provide certain clarifications regarding how the modified CEM approach would operate in the clearing context. Specifically, the Agencies should clarify that the modified CEM approach would permit the netting of offsetting positions (*e.g.*, identical reference asset and maturity) booked under different "desk IDs" or "hub accounts" for a given clearing member, such that the exposure amount calculated under the modified CEM approach would more accurately reflect the actual economic exposure of the QCCP to those positions.

### C. Eligibility Criteria for 2 Percent Risk Weight for Clearing Member Clients

As proposed, a banking organization that is a clearing member client would apply a 2 percent risk weight to a trade exposure amount to a QCCP, if certain criteria are met. If the criteria are not met, the clearing member client must generally apply a 4 percent risk weight to the trade exposure amount. The criteria include that (i) the collateral posted by the banking organization to the QCCP or clearing member must be subject to an arrangement that prevents any losses to the clearing member due to the joint default or a concurrent insolvency, liquidation or receivership proceeding of the clearing member and any other clients of the clearing member; and (ii) the banking organization that is a clearing member client has conducted sufficient legal review to conclude with a well-founded basis (and maintains sufficient written documentation of that legal review) that in the event of a legal challenge (including one resulting from default or a liquidation, insolvency, receivership or similar proceeding), the relevant court and administrative authorities would find the arrangements to be legal, valid, binding and enforceable under the law of the relevant jurisdiction.

[79] In this respect, the Associations note that neither the CFTC's final rule establishing core principles for DCOs nor the SEC's proposed standards for SBSCAs require regulatory approval of a CCP's internal margin models. Rather, the CFTC's final rule requires a DCO's margin models to "be risk-based and reviewed on a regular basis," "meet an established confidence level of at least 99 percent, based on data from an appropriate historic time period," and "be reviewed and validated by a qualified and independent party, on a regular basis." *See* 17 C.F.R. § 39.13(g). Likewise, the SEC's proposed standards require SBSCAs to use risk-based models and parameters to set margin requirements and to review such models and parameters at least monthly. *See* Proposed 17 C.F.R. § 240.17Ad–22(b)(2). The Federal Reserve Board's risk-management standards for systemically important FMUs also do not require an FMU that operates as a CCP to obtain regulatory approval of its internal margin models.

In the preamble to both the Standardized Approach NPR and the Advanced Approaches NPR, the Agencies expressed the view that omnibus accounts (that is, accounts that are generally set up by clearing entities for non-clearing members) in the United States would satisfy the above-mentioned criteria because of the protections afforded to client accounts under certain regulations of the SEC and CFTC. The Associations believe that the Agencies' recognition of these arrangements should be codified in the rule text. In addition, the Agencies should confirm that, with respect to major financial jurisdictions outside the United States, the "sufficient legal review" requirement can be satisfied by reasoned reliance on a commissioned legal opinion.

### D. Need for Greater Incentives to Clear Client Trades

Under the Agencies' proposal, a cleared transaction would *not* include an exposure of a banking organization that is a clearing member to its clearing member client if either the banking organization is acting as a financial intermediary and enters into an offsetting transaction with a CCP or the banking organization provides a guarantee to the CCP on the performance of the client. Such a transaction would instead be treated as an OTC derivative transaction and would therefore not benefit from the 2 percent risk weight that applies to a clearing member's trade exposures to a QCCP.[80] This means that a clearing member banking organization could potentially be required to hold more capital when it clears a trade on behalf of a client through a CCP than when it enters into an uncleared trade on behalf of the same client. Specifically, the client-facing leg of a cleared transaction would be treated as a bilateral OTC derivative.[81] In addition, under the Agencies' proposals, the banking organization would incur (i) a separate capital charge for the CCP-facing leg of that transaction (if the banking organization acts as a financial intermediary between the client and the CCP by entering into a transaction with the client and an offsetting transaction with the CCP[82] or is obligated to reimburse the client for any losses suffered due to changes in the value of its transactions in the event that the CCP defaults); and (ii) a capital charge for the banking organization's default fund contribution to the CCP.

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[80] For the avoidance of any doubt, the Agencies should clarify in their final rules that a clearing member banking organization would *not* need to hold any capital with respect to client trades where it *neither* guarantees the performance of the clearing member client to the CCP *nor* acts as a financial intermediary between the client and the CCP.

[81] As noted above, under the Basel Committee's interim framework for exposures to CCPs, to recognize the shorter close-out period for cleared transactions, clearing members can capitalize the exposure to their clients by applying a margin period of risk of at least 5 days (if they adopt the IMM) or multiplying the EAD by a scalar of no less than 0.71 (if they adopt the CEM).

[82] As discussed above, the Basel Committee's July 2012 interim framework makes it clear that a banking organization's role solely as "a financial intermediary between a client and a CCP," in the absence of a guaranty of the CCP's obligations to the client, does not attract a trade exposure capital charge.

As the Agencies acknowledge in the preamble to their proposals, the capital treatment outlined above would create a disincentive for banking organizations to act as intermediaries and provide access to CCPs for clients. The Associations believe that, rather than disincentivizing central clearing,[83] the capital framework for cleared transactions should provide appropriate incentives for clearing member banking organizations to clear trades on behalf of their customers, consistent with the G-20 commitments toward the central clearing of standardized derivative products. While the Associations appreciate the slight adjustments in the Basel Committee's interim framework to address this issue, they do not believe that these revisions go far enough. At a minimum, the capital charge for the client-facing legs of cleared transactions should reflect a lower exposure amount or lower risk weight (for example, capped at 50 percent of the exposure amount or risk weight that would otherwise apply) and, under the advanced approaches capital framework, a lower EAD or probability of default ("**PD**") (for example, capped at 50 percent of the EAD or PD that would otherwise apply).

## X. Collateralized Transactions

Under the Standardized Approach NPR, a banking organization would be able to recognize the risk-mitigating effects of financial collateral using the "simple approach" for certain exposures and using the "collateral haircut approach" for repo-style transactions, eligible margin loans, collateralized derivative contracts and single-product netting transactions. Under the collateral haircut approach, a banking organization may use the standard supervisory haircuts in § __.37(c)(3) or, with prior written approval by the federal prudential regulator, its own estimates of haircuts pursuant to § __.37(c)(4).

The Associations request that any re-proposal of the Standardized Approach NPR eliminate the 20 percent risk weight floor under the simple approach. In addition, the Associations believe that the proposed standard supervisory haircut approach is overly conservative and does not reflect the actual risk of such transactions. Any re-proposed rule therefore should adopt a market-based haircut approach and not apply haircuts to certain low risk, over-collateralized transactions. Finally, the Associations believe the Agencies should permit use of the simple value-at-risk ("**VaR**") approach to calculate exposures to repo-style transactions and eligible margin loans.

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[83] The bank capital-related disincentives to centrally clear trades would be exacerbated by the problems created under the proposed Dodd-Frank Act Section 165 enhanced prudential standards, which fail to exempt exposures to CCPs from the single counterparty exposure limits.

### A. Eliminate Risk Weight Floor

The proposal permits banking organizations to use the simple approach for any exposure where the collateral is subject to a collateral agreement for at least the life of the exposure; the collateral is revalued at least every six months; and the collateral (other than gold) is denominated in the same currency.[84]

With certain exceptions, the risk weight assigned to the collateralized portion of a transaction under the simple approach is subject to a 20 percent risk weight floor. The Associations believe that the risk weight floor will result in inconsistencies between the treatment of collateral and the equivalent on-balance sheet exposure. Any re-proposed rule should remove the risk weight floor to recognize the full benefit of collateral that is subject to zero percent risk weight.

### B. Proposed Collateral Haircuts Approach is Overly Conservative and Overstates Risk

The Associations have a number of concerns regarding the proposed standard supervisory haircut approach. Overall, the proposed exposure amount formula and haircuts are too conservative and overstate the risk of many collateralized transactions.

First, several of the proposed standard supervisory haircuts do not recognize credit quality or maturity, which is a significant divergence from International Basel II. This discrepancy is particularly problematic for corporate bonds. Under International Basel II, corporate bonds receive a 2 to 12 percent haircut depending on the maturity and credit rating of the bond. By contrast, under the Standardized Approach NPR, *all* non-bank corporate bonds receive a 25 percent haircut regardless of credit quality or maturity.[85] This flat 25 percent haircut makes even less sense relative to collateral that does not meet the definition of financial collateral. For example, non-investment-grade bonds do not qualify as eligible financial collateral and therefore receive a 25 percent haircut. At the same time, investment-grade corporate bonds that meet the definition of eligible collateral receive the same 25 percent haircut.

Similarly, all sovereign exposures with a 100 percent risk weight would receive the same 15 percent haircut whether they mature in less than a year or more than 5 years and whether they are investment-grade or not.[86] The Agencies do not provide any support—either

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[84] Standardized Approach NPR at 52,958, § __.37(b).

[85] Under the Standardized Approach NPR, all non-bank corporate bonds are risk-weighted at 100 percent under Section ___.32. Thus, assuming a ten-business-day holding period, corporate bonds receive a 25 percent haircut. *See* Standardized Approach NPR § __.37(c)(3), Table 8.

[86] *See id.*

qualitative or quantitative—for these flat, risk-insensitive haircuts or for eliminating any recognition of credit quality or maturity.

Second, the proposed standard supervisory haircuts would result in the inconsistent treatment of collateral with zero percent risk weight and the equivalent balance sheet exposure. This treatment is inappropriate because it would run counter to the purposes underlying collateral haircuts. In theory, haircuts reflect the perceived risk associated with collateral. Thus, applying a haircut to essentially riskless collateral, such as cash, U.S. Treasury obligations, or other high quality sovereign debt, is inconsistent with the purposes underlying the haircut approach.

The proposal is overly conservative and not sufficiently risk-sensitive in several additional respects. For example, the proposed collateral haircut approach:

- Does not recognize collateral portfolio diversity even though one of the key components to a successful risk-mitigation strategy is to diversify collateral among different asset classes and maturities;
- Assumes that every security position—both securities borrowing and securities lending—will move in an adverse direction; and
- Assumes that foreign exchange rates on every foreign currency exposure will move in an adverse direction.

### C. Recommended Alternatives to Collateral Haircut Approach

Given the many shortcomings of the collateral haircut approach, any re-proposed rule should (1) adopt a market-based haircut approach; (2) not apply haircuts to transactions over-collateralized by cash or high quality sovereign debt marked to market daily; and (3) reinstate the simple VaR approach.

#### 1. Adopt Market-Based Haircuts Approach

The Associations strongly support a market-based haircuts approach in place of the standard supervisory haircuts. A market-based haircut approach would allow banking organizations sufficient buffer to protect against asset volatility while also recognizing different risk profiles depending on credit quality, maturity and liquidity. Alternatively, any standard supervisory haircut approach should, at the very least, account for credit quality and maturity of the collateral.

### 2. Not Apply Haircuts to Transactions Over-Collateralized by Cash or High Quality Sovereign Debt Marked to Market Daily

The proposed market price volatility and currency mismatch haircuts apply indiscriminately to programs in which collateral is cash, high quality sovereign debt (sovereigns with a CRC rating of 0 or 1, including U.S. Treasury obligations), or other types of assets. This one-size-fits-all treatment is unnecessary and unwarranted. Transactions that are over-collateralized by cash or high quality sovereign debt and marked to market daily bear an extremely low risk of loss, and, to our knowledge have historically have suffered no losses from counterparty default. In fact, because of the inherent safety of these transactions, for decades they have received a zero percent risk-weight under the existing risk-based capital rules. Consistent with this low risk profile, the Associations request that the market price volatility and currency mismatch haircuts not apply to transactions over-collateralized by cash or high quality sovereign debt and marked to market daily.

First, the market volatility haircuts should not apply because the implicit rationale underlying the haircuts does not apply to such transactions. Market price volatility haircuts reflect the perceived market price risk associated with a particular asset in its own right. The application of these market price volatility haircuts as proposed implicitly assumes a detrimental price movement. This underlying rationale does not apply to transactions over-collateralized and marked to market daily with essentially riskless collateral such as cash, U.S. Treasury obligations, or other high quality sovereign debt such as German Bunds. Cash and high-quality sovereign debt are liquid, low volatility, and low risk assets. The existing risk-based capital rules and the proposed rules recognize the extremely low risk of these assets, and accordingly assign a zero percent risk weight to cash, exposures to the U.S. government, and exposures to other sovereigns with a 0 or 1 CRC rating.[87] To the extent that cash or high quality sovereign debt is volatile during periods of market stress, such assets have gained value against loaned securities in investors' "flight to quality." Moreover, in the rare instance that the value of a loaned security might exceed the value of cash or high quality sovereign debt, daily collateral calls would bridge the gap.

Second, the currency mismatch haircut also should not apply to transactions over-collateralized by cash or high quality sovereign debt marked to market daily. The industry already has recognized and addressed the potential risk from a currency mismatch between loaned securities and collateral by requiring excess margin for transactions in which the currencies of the loaned securities and collateral differ. Standard industry practice is to collateralize securities loans at 102 percent where there is a currency match and 105 percent where there is a currency mismatch. Based on the low to nonexistent rate of historical losses,

[87] *See* Standardized Approach NPR, 77 Fed. Reg. 52,894-95.

this over-collateralization of cash and high quality sovereign debt has been more than sufficient.

Furthermore, the 8 percent currency mismatch haircut might perversely encourage banking organizations to incur additional risk because the haircut does not apply where the transaction is denominated in one currency. For example, the proposed rules would not impose a currency mismatch haircut on a loan of Japanese securities against Japanese sovereign debt, but would impose an 8 percent haircut on a loan of Japanese securities against more liquid and less volatile U.S. Treasury securities.

Given the actual and demonstrated low risk of such transactions, any re-proposed rule should not apply market price volatility haircuts or a currency mismatch haircut to transactions over-collateralized by cash or high quality sovereign debt that is marked to market daily. High quality sovereign debt can be easily and clearly defined as the debt of sovereigns that receive a 0 or 1 CRC rating and a corresponding zero percent risk weight under the risk-based capital rules so there should be no question in the market as to whether the haircut rules do, or do not, apply.[88]

### 3. Permit Use of the Simple VaR Approach

For purposes of calculating exposures to repo-style transactions and eligible margin loans, the Standardized Approach NPR would eliminate the simple VaR approach—which is permitted under International Basel II—in favor of the collateral haircut approach. This departure from international capital standards is unwarranted because the simple VaR approach is a practical and risk sensitive measure that better aligns capital requirements with actual risk of repo-style transactions and eligible margin loans, including agency-indemnified lending undertaken on behalf of clients. The simple VaR approach is widely used as an efficient and effective risk management tool across the financial services industry for institutions of all sizes. Many institutions that do not have sufficient capability to run the IMM may nonetheless use the simple VaR. Therefore, allowing banking organizations to use the simple VaR approach would reduce regulatory burden on banking organizations while also enhancing risk sensitivity.

Failure to allow use of the simple VaR model would also create disparity between banking organizations that are subject to U.S. capital requirements and those that are not, and constrain an important source of market liquidity. To avoid these undesirable consequences, the Agencies should permit banking organizations that are subject to U.S. capital

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[88] *See* Standardized Approach NPR, 77 Fed. Reg. 52,949, § __.32(a). Under this recommended treatment, transactions over-collateralized by cash or high quality sovereign debt marked to market daily would have an exposure amount of zero.

requirements to continue to use supervisory-approved simple VaR models to calculate exposures to repo-style transactions and eligible margin loans.

## XI. Securitization Exposures

Under the proposal, a banking organization generally would calculate the amount of a securitization risk weight by applying the SSFA, the gross-up approach or a 1,250 percent risk weight.[89]

The Associations strongly support and appreciate the inclusion of the gross-up approach in the Standardized Approach NPR. The gross-up approach will reduce the implementation burden for smaller banks and allow banking organizations to tailor the securitization rules to their individual risk profiles. However, given the complex and sweeping proposed changes to the capital treatment of residential mortgages, few banking organizations will actually be able to use the gross-up approach unless legacy mortgages are grandfathered. As discussed above, it will be very difficult, if not impossible in some instances, for banking organizations to gather sufficient data to determine applicable risk weights for legacy exposures. The Associations therefore request that any re-proposal of the Standardized Approach NPR grandfather legacy mortgage exposures in order to facilitate use of the gross-up approach.

In addition, any re-proposal of the Standardized Approach NPR should:

- Narrow and clarify the definition of securitization;
- Narrow the definition of resecuritization;
- Cap risk weights at the equivalent of a dollar-for-dollar deduction in capital equal to the value of the asset;
- Modify the SSFA formula to be more risk-sensitive;
- Clarify the new due diligence requirements; and
- Clarify the deduction for an after-tax gain-on-sale associated with a securitization exposure.

### A. Narrow and Clarify Definition of Securitization

The Agencies propose to broadly define "securitization exposure" as "an on-balance sheet or off-balance sheet credit exposure (including credit-enhancing representations and

[89] Standardized Approach NPR § __.42(a).

warranties) that arises from a traditional securitization or synthetic securitization (including resecuritization)."[90] A "securitization exposure" also includes any exposure that "directly or indirectly references" such a securitization exposure.[91] The Agencies explain that this broad definition is designed to address the tranching of credit risk of the underlying exposures.[92]

This definition of "securitization exposure" is too broad. First, the definition of securitization exposure should focus on the tranching *and pooling* of risk because the credit risk of underlying exposures depends on both factors. Further, the Associations believe that the "directly or indirectly references" standard is ambiguous and requires clarification. In fact, the Agencies stated that they "are concerned that the line between securitization exposures and non-securitization exposures may be difficult to draw in some circumstances."[93] The preamble to the Standardized Approach NPR attempts to clarify this line by explaining that a banking organization's primary federal supervisor will determine whether an exposure is a securitization or not by considering "the economic substance, leverage, and risk profile of transactions" and that such a determination "would be guided by the economic substance of a transaction rather than its legal form."[94] This vague and subjective determination by a bank's primary federal supervisor plainly does not allow banking organizations to determine in advance whether an exposure is a securitization for purposes of calculating total risk-weighted assets. As such, banking organizations may have to hold substantially higher levels of capital to compensate for the possibility that exposures may be deemed securitizations.

The Associations appreciate that the proposed definition of securitization, for regulatory capital purposes, would exclude investment funds, collective investment funds, pension funds regulated under ERISA and their foreign equivalents, and transactions regulated under the Investment Company Act of 1940 and their foreign equivalents.[95] This is appropriate because these entities and transactions do not involve securitization tranching as contemplated by the international Basel capital framework, and placing them outside the securitization framework would avoid a torrent of duplicative applications for exemption from multiple organizations. Other types of counterparties should be considered for exclusion as well, such as investment funds related to securities clearing and prime brokerage activities,

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[90] Basel III Numerator NPR § ___.2 (Definitions).

[91] *Id.*

[92] Standardized Approach NPR at 52,915.

[93] *Id.* at 52,914.

[94] *Id.* at 52,915.

[95] *See* Basel III Numerator NPR § ___.2 (Definition of "Traditional Securitization"); Standardized Approach NPR at 52,914; Advanced Approaches NPR at 53,043.

irrespective of whether the fund is regulated. Moreover, while exclusion for certain types of counterparties is a positive step, exclusions based on transaction structure can also be justified in consideration of the economic substance of the exposure. The Associations believe that the appropriate capital treatment for exposures to other types of funds, including hedge funds and private equity firms, should be assessed based on the counterparty's ability to exercise unfettered control over the capital structure. The appropriate methodology (*e.g.*, repo or wholesale) should first be applied to determine the exposure at default, which would then be run through the appropriate capital framework. The Associations recommend that the Agencies consult with the industry to develop a suitable list of exemption exposure characteristics.

In addition, the Associations seek confirmation that limited guarantees of commercial and industrial ("**C&I**") loans and CRE loans would not be treated as traditional or synthetic securitizations. The definitions of both "traditional securitization" and "synthetic securitization" require that "[a]ll or substantially all of the underlying exposures are financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities)."[96] Although a commercial loan to an operating company or a real estate project could have tranched credit risk, the underlying asset in such a transaction is real estate, an operating company or other non-financial assets, and not financial exposures.[97] Limited guarantees of C&I and CRE loans therefore should not be treated as securitizations under any re-proposal of the Standardized Approach NPR.

These recommended changes would provide a clearer definition of "securitization" and give banking organizations greater guidance as to the scope of exposures that are subject to the securitization framework.

### B. Narrow the Definition of Resecuritization

The Agencies propose to define "resecuritization" as any "securitization in which one or more of the underlying exposures is a securitization exposure" and would define "resecuritization exposure" even more broadly to include any on- or off-balance sheet exposure to a resecuritization and any exposure that directly or indirectly references a

[96] Basel III Numerator NPR § ___.2 (Definitions).

[97] At least some members of the Associations have requested clarification of this issue in other contexts. *See, e.g.*, Letter from Robert W. Strand. American Bankers Association, to Anna Lee Hewko, Federal Reserve Board; Amrit Sekhon, OCC; and Jason Cave, FDIC (Aug. 22, 2012), *available at* http://www.aba.com/Issues/LetterstoCongress/Documents/LetteronCommercialLoanswithLimitedGuaranteesasSyntheticSecuritization.pdf.

resecuritization.[98] The Associations request the Agencies to adopt two exemptions to this definition.

### 1. Exempt *De Minimis* Resecuritizations

The broad proposed definition of resecuritization exposure will have a detrimental effect on business lending. Existing corporate loan securitizations, or collateralized loan obligations ("**CLOs**"), often include a *de minimis* amount of other corporate loan-backed securitizations to ensure appropriate risk diversification for investors. Such securitizations will be deemed resecuritizations under the Standardized Approach NPR and, importantly, will be subject to substantially higher capital requirements because the SSFA formula increases parameter $p$ from 0.5 to 1.5 for resecuritizations. Thus, securitization exposures with a *de minimis* amount of underlying securitizations would continue to apply a 0.5 $p$ constant.

Such CLOs with *de minimis* underlying securitization exposures should not be deemed resecuritizations. The Associations instead request the Agencies to define the term "resecuritization" as a securitization position in which 5 percent or more of the underlying exposures are securitization positions. This definition is consistent with previous market standards that generally capped resecuritizations at 5 percent of the pool.[99] Moreover, the 1.5 $p$ constant for arbitrage CLOs is unnecessarily punitive because such CLOs suffered few losses through the 2008 financial crisis.[100]

As an alternative to the *de minimis* approach, the Associations request the Agencies to modify the SSFA for re-securitizations so that parameter $p$ is weighted by the mix of underlying securitization exposures (1.5 $p$ constant) and underlying non-securitization exposures (0.5 $p$ constant) for up to 5 percent of underlying securitizations. Any transaction with more than 5 percent securitizations in underlying assets would be deemed a resecuritization and calculated using a $p$ constant of 1.5.

### 2. Exempt Resecuritizations of Senior Tranches of a Single Underlying Security

In addition, resecuritizations involving a senior tranche of a single underlying security should not be treated as resecuritizations. A resecuritization of a senior tranche, such as a re-REMIC, is analogous to owning a super-senior position in the underlying reference securitization and is used as a risk-reducing measure. Under the proposal, such positions

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[98] Basel III Numerator NPR § ___.2 (Definitions).

[99] *See* J.P. Morgan, *U.S. Fixed Income Strategy* (June 15, 2012).

[100] *See* Moody's Investor Services, *CLO Interest 4* (July 2012).

would be subject to a much higher capital charge for the resecuritized senior position than for the reference securitization itself.

### C. Replace 1,250 Percent Risk Weight with Maximum Risk Weights that Correspond with Phased-in Increases in Required Capital Ratios

The Standardized Approach NPR would require a banking organization to apply a 1,250 percent risk weight to securitization exposures for which it does not use the SSFA or the gross-up approach.[101] In addition, a banking organization would apply a 1,250 percent risk weight to the portion of a credit-enhancing interest-only strip ("**CEIO**") that does not constitute an after-tax gain-on-sale and to any securitization exposure for which the bank cannot meet due diligence requirements.[102] As discussed above, the Associations believe that the proposed 1,250 percent risk weight for certain securitization and other exposures is inappropriate because it would require banking organizations with a total capital to total risk-weighted assets ratio of greater than 8 percent to hold more than a dollar of capital for every dollar of securitization exposure. This would be the case under the Basel III Numerator NPR, which, over time, would require banking organizations to maintain a total capital to total risk-weighted assets ratio of at least 10.5 percent (minimum required capital ratio plus capital conservation buffer) to avoid limitations on capital distributions and discretionary bonus payments to executive officers. The Associations therefore request the Agencies to adopt the Transitional Arrangements for Maximum Risk Weights set forth in **Table B-1** above so that required capital for certain exposures would be equal to but would not exceed the value of the underlying asset.

### D. Clarify that Securitization Exposures Are Not Subject to a Capital Deduction

The Associations request that any exposure that meets the definition of a "securitization exposure," such as collateralized debt obligations ("**CDOs**") backed by trust preferred instruments, would not also be subject to a corresponding deduction from capital consistent with non-significant investments in the capital of an unconsolidated financial institution. Because these securities are written down if "other than temporary impairment" ("**OTTI**") occurs, the carrying value of the instruments only reflects cash flows that are expected to ultimately be collected. In addition, under the Standardized Approach NPR, these securities are subject to super-risk weighting, using either the SSFA or the gross-up approach, according to their location in the capital structure and remaining credit protection. To also require that holdings in excess of 10 percent of capital be deducted would be unnecessarily punitive given the OTTI process and super-risk weighting that is already applied. In addition,

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[101] Standardized Approach NPR § ___.44(a).

[102] Standardized Approach NPR §§ __.41(c)(1); __.42.(a)(1).

a simplistic capital deduction fails to recognize the level of credit support these securities possess, which can be more appropriately dealt with through the SSFA or gross-up approach. At a minimum, the Associations request an increase of the level at which a capital deduction would occur from 10 percent to 20 percent.

### E. Modify Simplified Supervisory Formula Approach

To calculate the risk weight for a securitization exposure using the SSFA, a banking organization must have accurate information on the following five inputs: (i) $K_G$, the weighted-average total capital requirement of the underlying exposures calculated using the standardized approach; (ii) parameter $W$, the current amount of delinquencies on the underlying exposures of the securitization; (iii) parameter $A$, the attachment point for the exposures; (iv) parameter $D$, the detachment point for the exposures; and (v) parameter $p$, a supervisory calibration constant.

The Associations previously commented on numerous issues related to the proposed SSFA formula in the context of the Market Risk Capital Rule.[103] Although the Agencies addressed some of these concerns about the SSFA as described in the Market Risk Final Rule[104] and the Standardized Approach NPR, the Associations continue to believe that the SSFA is deficient and will not adequately capture the risk of securitization exposures. In fact, the Standardized Approach NPR would magnify many of the issues in the SSFA due to its broader scope of application. The Associations thus request the Agencies to reconsider the issues raised in the Associations' prior comment letter.

The Associations also wish to reiterate a number of concerns with the proposed SSFA formula and therefore request that it be modified to:

- Adopt a flexible approach to the data inputs for the SSFA;
- Recognize underlying asset quality, performance and recovery rates in the $K_G$; and
- Recognize soft credit support in parameter $A$.

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[103] *See* Letter from The Clearing House Association, American Bankers Association, American Securitization Forum, Financial Services Roundtable, International Swaps and Derivatives Association and Securities Industry and Financial Markets Association to the Federal Reserve Board, OCC and FDIC (Feb. 7, 2012), *available at* http://www.theclearinghouse.org/index.html?f=073573.

[104] OCC, Federal Reserve Board and FDIC, *Risk-Based Capital Guidelines: Market Risk*, 77 Fed. Reg. 53,060 (Aug. 30, 2012) ("**Market Risk Final Rule**").

### 1. Clarify Data Necessary for SSFA Inputs

Given the detailed new rules for residential mortgages and other assets under the Standardized Approach NPR, the Associations believe that it would be difficult to obtain data to determine $K_G$, the weighted-average total capital requirement of the underlying exposures calculated using the standardized approach. The Associations therefore seek guidance on the types of data that are sufficient to determine $K_G$ for the SSFA formula as well as the required time frame to obtain such data.

First, many types of data necessary for the $K_G$ calculation might not be available. The Standardized Approach NPR makes very fine distinctions for residential mortgage exposures, requiring originators and investors in residential mortgage-backed securities ("**RMBS**") to obtain detailed information about underwriting standards, LTV ratios, loan modifications, second mortgages and delinquencies on all the underlying assets. For instance, the Associations are not aware of any organization that reports all data categories required for the SSFA, including delinquency rates. Other information is extremely difficult to collect, particularly detailed information on underwriting characteristics. Furthermore, while such data may be available at the pool- or portfolio-level, it may not be available at the individual loan level. The lack of available information for legacy mortgage assets further supports grandfathering legacy residential mortgage assets, with the exposures subsequently processed through the SSFA.

These problems are exacerbated with respect to securitizations of foreign assets. The international Basel capital framework does not require such fine gradations for residential mortgages, so originators in other countries likely do not maintain data necessary to distinguish a category 1 from a category 2 mortgage or to calculate the CLTV ratio of a HELOC. Thus, such data are not only difficult to obtain, but also may be impossible to obtain from foreign originators. As an alternative to determining $K_G$ for foreign assets, the Associations request that an institution should be able to demonstrate that certain foreign assets have been originated consistent with prudent underwriting standards established in the foreign jurisdiction, in determining whether such assets should be classified as category 1 or category 2.

Additionally, assuming banking organizations could obtain affordable and reliable information about underlying assets sufficient to calculate $K_G$, such information would not be available immediately. The Associations thus seek further clarification as to when a banking organization must perform the SSFA calculation.

To address these and similar concerns in the context of the Supervisory Formula Approach ("**SFA**"), the Agencies have permitted banking organizations to use alternative estimates or proxies to calculate risk weights until data to perform the SFA become available. The Associations strongly support this flexible approach and request the Agencies to adopt this approach in the context of the SSFA as well. Under this flexible approach, banking organizations would be permitted to use conservative proxies and estimates of data inputs for the SSFA until more accurate data become available. If such data are not available or not reliable, *e.g.*, for foreign assets, then the banking organizations should be permitted to use conservative proxies and estimates for the SSFA on a permanent basis. Finally, the Associations seek clarification that pool- or portfolio-level data are sufficient for SSFA inputs.

### 2. Recognize Underlying Asset Quality, Performance and Recovery Rates

The proposed $K_G$ is not sufficiently risk-sensitive and overstates the risk of securitization exposures. The quality and performance of underlying assets are fundamental determinants of the performance of an asset-backed security ("**ABS**"). Yet, the blunt $K_G$ formula ignores differences in the credit quality of underlying exposures within the same broad category. For example, prime auto loans tend to perform better than non-prime auto loans, but the proposed $K_G$ does not distinguish between the two. Similarly, the $K_G$ input does not recognize recovery rates on the underlying loan.

Failure to recognize underlying asset quality is especially problematic because the proposed SSFA recognizes external credit enhancements. Credit enhancements cannot be considered in isolation without underlying asset quality; in many instances, credit enhancements compensate for low-quality assets. Recognition of one without the other results in perverse and counterintuitive capital requirements. For example, under the proposed SSFA, a securitization with low-quality assets—which the proposal does not recognize—and significant credit enhancements—which the proposal does recognize—results in a low risk weight under the SSFA. By contrast, a securitization with high-quality assets but no credit enhancements likely results in a higher risk weight, even though such assets do not require credit enhancements precisely because they are of high credit quality. The proposed KG formula thus penalizes banking organizations for investing in higher credit quality transactions. Over time, the lack of risk-sensitivity will encourage investment in low-quality, higher-yielding assets as well as increase the price of high-quality assets to compensate for higher capital requirements.

The lack of risk-sensitivity also may incentivize regulatory arbitrage between the SSFA and SFA for a banking organization subject to the advanced approaches. That is, a banking organization may simultaneously obtain a lower risk weight for high-quality assets using the more risk-sensitive SFA and a lower risk weight for low-quality assets using the less risk-sensitive SSFA.

Modifying the SSFA to make $K_G$ more risk-sensitive would alleviate many of these concerns. As such, the Associations strongly urge the Agencies to revise the SSFA to incorporate underlying asset quality, performance and recovery rates in the $K_G$. Recognition of these factors would make the SSFA substantially more risk-sensitive and the risk weight calculation more accurate.

### 3. Recognize Soft Credit Support

The Standardized Approach NPR does not recognize so-called "soft credit support" for securitization exposures. Although this issue was discussed in the context of the Market Risk Final Rule, the Associations would like the Agencies to consider this issue in light of the broad proposed scope of application and potentially far broader impact of the Standardized Approach NPR. For example, the proposal does not recognize excess spreads as a soft credit enhancement. The excess spread between interest received on underlying assets and the coupons paid is one of the primary risk mitigants used in ABS. The Agencies have long recognized that "[e]xcess spread represents the first line of protection against credit losses and avoiding early amortization. As such, excess spread represents the primary internal credit enhancement facility and is built into every securitization."[105] In light of this guidance, the Associations strongly urge the Agencies to incorporate excess spread in the SSFA.

Similarly, the SSFA ignores the carrying value of a securitization position in determining its attachment point. Where the carrying value of a securitization is less than its par value, the discount to par for a particular position provides additional protection for potential write-downs on the pool of underlying assets. Thus, the difference between the carrying value and par value is effectively a credit enhancement that reduces the risk of a securitization exposure. Failure to recognize this type of soft credit enhancement greatly overstates the exposure amount. To correct for this overstatement, any re-proposal of the Standardized Approach NPR should incorporate carrying value in the SSFA by modifying the calculation of parameter $A$ (the attachment point).

## F. Clarify Due Diligence Requirements

The Standardized Approach NPR would require a banking organization to "demonstrate, to the satisfaction of its primary federal supervisor, a comprehensive understanding of the features of a securitization exposure that would materially affect the performance of the exposure."[106] Although the complexity of each analysis would depend on "the complexity of the exposure and the materiality of the exposure in relation to capital," a

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[105] FDIC, *Credit Card Securitization Manual* (2007), *available at* http://www.fdic.gov/regulations/examinations/credit_card_securitization/ch6.html#2sub1; *see also* OCC, *Asset Securitization: Comptroller's Handbook*, 21-22 (Nov. 1997), *available at* http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/assetsec.pdf (recognizing excess spread as an internal credit enhancement).

[106] Standardized Approach NPR at 52,915.

banking organization must analyze four fundamental factors for each exposure: (i) structural features of the securitization that would materially impact the performance of the exposure; (ii) relevant information regarding the performance of the underlying credit exposure(s); (iii) relevant market data of the securitization; and (iv) for resecuritization exposures, performance information on the underlying securitization exposure.[107] A banking organization that fails to demonstrate a "comprehensive understanding" of the securitization exposure to its primary federal supervisor would be required to assign a 1,250 percent risk weight to the exposure.

The Associations agree that a banking organization must perform rigorous due diligence to understand the risk of its potential investments. Specifically, the Associations agree that both the structural features of a securitization and the performance of the underlying collateral are indicative of the risk of the investment. However, any re-proposal of the Standardized Approach NPR should reflect the following additional considerations.

First, the Associations do not believe that the market data requirements (*e.g.*, requiring banking organizations to consider bid/ask spreads and price volatility) add substantially to the due diligence risk analysis. More importantly, these data are nearly impossible to obtain in less liquid markets with very few new issuances (*e.g.*, non-agency MBS). Similarly, market data would be difficult to source for other sectors, such as credit card or auto, if they were to slow down considerably. Such market data requirements likely would cause the industry to retreat from these markets, thereby decreasing liquidity and making it more difficult for securitizations to support a rebound in consumer lending. The Associations believe that the guidance[108] issued by the OCC regarding due diligence requirements in determining whether securities are eligible for investment by a national bank or federal savings association reflects the preferred approach—*i.e.*, structural features and collateral performance, rather than market data, are the true indicators of a security's risk.

Second, the Associations urge the Agencies to clarify in any re-proposal of the Standardized Approach NPR that pool-level data are sufficient to complete the due diligence analysis. For the reasons described above, the Associations believe it is not feasible to obtain accurate, granular data regarding underlying loan-level credit exposures, especially residential mortgage and foreign exposures, within a short time frame.

Third, the Associations request that, if the Agencies retain the four-factor analysis, they confirm that completion of the analysis satisfies the due diligence requirement.[109] That

[107] Standardized Approach NPR § ___.41(c)(2)(i).

[108] OCC, *Guidance on Due Diligence Requirements in Determining Whether Securities are Eligible for Investment*, 77 Fed. Reg. 35,259 (June 13, 2012).

[109] As described in the previous paragraph, the Associations strongly urge the Agencies to adopt a three-factor analysis by abandoning the market data factor.

is, so long as a banking organization performs and completes the four-factor analysis, it may assign risk weights under the SSFA or gross-up approach, and not the 1,250 percent risk weight. The Associations believe that this standard would be much clearer than an ambiguous standard that requires banking organizations to demonstrate a "comprehensive understanding" of the securitization exposure.

Finally, the Associations urge the Agencies to adopt a more flexible due diligence regime. The current proposal imposes a punitive 1,250 risk weight on banking organizations for any failure to meet the due diligence requirements and provides no opportunity to remediate. This rigid approach would be unworkable in practice because banking organizations inevitably will make good faith mistakes or the necessary data might not be available. The Associations therefore recommend that the Agencies adopt the remedial approach incorporated into Article 122a of the EU's second Capital Requirements Directive ("**CRD II**"), which allows regulatory authorities to progressively increase the risk weight assigned to the exposure depending on the severity and duration of the infringement.[110] Although CRD II provides a formula for the progressively higher risk weights, it also advises regulators to take into account "the materiality and risk context" of any violation.[111] A remedial scheme like the one proposed in CRD II would better align U.S. bank capital requirements with those in other major jurisdictions and would also more appropriately align the subjectivity inherent in the due diligence requirements with the penalties for noncompliance.

### G. Clarify Deduction for After-Tax Gain-on-Sale Resulting from a Securitization

The Basel III Numerator NPR would require a banking organization to deduct goodwill and other intangible assets (include servicing assets other than MSAs), net of DTLs, from CET1. The Standardized Approach NPR would require a banking organization to deduct any after-tax gain-on-sale resulting from a securitization—an item that could also include certain non-MSA servicing assets—from CET1. This could potentially lead to the same amount of non-MSA servicing assets being deducted twice from CET1. Accordingly, the Agencies should clarify in any re-proposal of the Standardized Approach NPR that for purposes of any capital deduction for an after-tax gain-on-sale resulting from a securitization, a banking organization may exclude any servicing asset that is part of its after-tax gain-on-

[110] *See* Committee of European Banking Supervisors, *Guidelines to Article 122a of the Capital Requirements Directive* (Dec. 31, 2010), *available at* http://www.eba.europa.eu/cebs/media/Publications/Standards%20and%20Guidelines/2010/Application%20of%20Art.%20122a%20of%20the%20CRD/Guidelines.pdf

[111] *See id.* at ¶ 109.

sale if such servicing asset is already captured by the proposed deduction for goodwill and other intangibles.

## XII. Equity Exposures

### A. Reduce Risk Weight for Publicly Traded Equity Exposures

Under the proposed Simple Risk-Weight Approach, the risk-weighted asset amount for each equity exposure would be the carrying value of the equity exposure multiplied by risk weights ranging from zero percent to 600 percent.[112] In a significant departure from the existing general risk-based capital rules and International Basel II, the Standardized Approach NPR would assign a 300 percent—rather than a 100 percent —risk weight to publicly traded equity exposures.[113]

This proposed increase in the risk weight for publicly traded equity exposures would disproportionately impact certain state-chartered mutual savings banks and other institutions. Mutual banks operate primarily at the local and community levels to promote saving by members and in certain cases are permitted to hold a greater percentage of equity exposures than other types of depository institutions. The proposed increase from 100 to 300 percent would have an enormous impact on such mutual banks because equity exposures account for nearly 25 percent of some mutual banks' assets. As such, the Associations request that any re-proposal of the Standardized Approach NPR maintain the current 100 percent risk weight for publicly traded equity exposures.

### B. Simplify Approach for Equity Exposures to Investment Funds

The Standardized Approach NPR would require separate treatment for equity exposures to an investment fund "to ensure that banking organizations do not receive a punitive risk-based capital requirement for equity exposures to investment funds that hold only low-risk assets, and to prevent banking organizations from arbitraging the proposed risk-based capital requirements for certain high-risk exposures."[114] However, to achieve that result, the Standardized Approach NPR would effectively impose a 1,250 percent risk weight on private securitization exposures (*i.e.*, securitization exposures that are not guaranteed by a government agency or GSE) held by an investment fund, regardless of the actual risk of the exposures. This approach penalizes equity exposures to investment funds that hold low-risk securitized assets and promotes investments in funds with high-risk assets—precisely what the Agencies stated they did not intend to do. Moreover, this treatment of equity exposures to

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[112] Standardized Approach NPR § __.52.

[113] Standardized Approach NPR at 52,967, § __.52(b)(5).

[114] Standardized Approach NPR at 52,927.

investment funds would cover a wide range of bank investments, such as separate account bank-owned life insurance ("**BOLI**") for employee benefit plans. To avoid these results, any re-proposal of the Standardized Approach NPR should limit the risk weight applicable to private securitization exposures held by certain investment funds.

### 1. The Standardized Approach NPR Imposes a 1,250 Percent Risk Weight on All Private Securitization Exposures Held by an Investment Fund, Regardless of Actual Risk

The Standardized Approach NPR proposes three approaches to calculate equity exposures to investment funds: the Full Look-Through Approach, the Simple Modified Look-Through Approach and the Alternative Modified Look-Through Approach.[115] A banking organization may use the Full Look-Through Approach only if it is able to calculate the risk-weighted asset amount for each of the exposures held by the investment fund.[116] Because investment funds typically do not provide investors with sufficient information to calculate the risk-weighted amount of a private securitization using the SSFA or the gross-up method, the only way a banking organization could use the Full Look-Through Approach for a fund holding such exposures would be by assigning a 1,250 percent risk weight to private securitization exposures. As described above, the 1,250 percent risk weight would result in a punitive, greater than dollar-for-dollar capital charge for well-capitalized institutions. The proposed approach thus would overstate the risk of private securitization exposures in the fund and impose punitive capital charges on equity exposures to funds with such exposures.

This problem is even more pronounced under the proposed Simple Modified and Alternative Modified Look-Through Approaches. Under both of these approaches, a banking organization is required to calculate the risk-weighted asset amount for its investment using the risk weight of the assets that the fund *could* acquire under its governing investment policies. Because a banking organization cannot apply the SSFA or the gross-up approach to a *hypothetical* securitization exposure, it appears that a banking organization using the Simple Modified Look-Through Approach would be required to assign a 1,250 percent risk weight to its *entire* equity exposure to an investment fund that has the ability to purchase even a *de minimis* amount of private securitizations.[117] Under the Alternative Modified Look-Through Approach, a banking organization must assume that the fund invests in the exposure type with the highest applicable risk weight to the maximum extent permitted by the prospectus.[118] Thus, a banking

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[115] Standardized Approach NPR § ___.53.

[116] Standardized Approach NPR § ___.53(a).

[117] Standardized Approach NPR § __.53(c). This is because under the Simple Modified Look-Through Approach a bank must assign its equity investment in the fund the highest risk weight of any asset that the fund may purchase.

[118] Standardized Approach NPR § __.53(d).

organization using this approach would be required to assign a 1,250 percent risk weight to the maximum percentage of private securitization exposures that the fund is permitted to acquire. Because the proposed rule imposes a high capital charge on equity exposures to investment funds that are permitted to invest in private securitization exposures, regardless of the actual risk or asset quality of those exposures, the proposed rule creates a perverse incentive to invest in funds with high-return, high-risk portfolios.

### 2. Adopt a Simplified Approach That Prevents Regulatory Arbitrage

The Associations propose an alternative approach that caps the risk weight applicable to private securitization exposures held by investment funds that limit their holdings of non-government, non-GSE securitizations to 25 percent or less of the fund's assets (an "**eligible fund**"). The Agencies should adopt this approach in any re-proposal addressing equity exposures to investment funds.

In light of the practical impossibilities of applying the SSFA or gross-up approaches to securitizations held by an investment fund, the Associations propose that banking organizations using the Full Look-Through, Simple Modified Look-Through or Alternative Modified Look-Through Approaches be permitted to assign a 100 percent risk weight to investment-grade private securitization exposures that are or could be held by an eligible fund. This 100 percent risk weight is the highest risk weight applicable to investment-grade exposures held by an investment fund under the current risk-based capital requirements for advanced approaches banking organizations.[119]

Similarly, the Associations propose that banking organizations using any of these three approaches be permitted to assign a 400 percent risk weight to non-investment-grade exposures that are or could be held by an eligible fund. This 400 percent risk weight cap is the highest risk weight applicable to non-investment-grade securitization exposures under the current risk-based capital requirements for advanced approaches banking organizations.[120]

Importantly, banking organizations should be permitted to rely on a fund's prospectus to determine whether a securitization is investment-grade. This approach is consistent with the Simple Modified and Alternative Modified Look-Through Approaches, which look only to a fund's prospectus or similar agreement.[121] Any requirement to further analyze whether a securitization is investment-grade or not would diminish the major benefit of these modified look-through approaches—to keep the risk-weighted asset calculation simple. Moreover, requiring banking organizations to conduct other due diligence would effectively negate the

[119] *See, e.g.*, 12 C.F.R. Part 225, Appendix G, Section 54(c) and Table 10.

[120] *See, e.g.*, 12 C.F.R. Part 225, Appendix G, Section 54(c) and Table 10.

[121] Standardized Approach NPR § __.53(c) and (d).

availability of the Simple Modified and Alternative Modified Look-Through Approaches, both of which are based on a fund's hypothetical holdings. Banking organizations cannot conduct due diligence on an unknown asset, just as they cannot apply the SSFA or the gross-up approach to such an asset.

The Associations propose to apply the 100 percent and 400 percent risk weight caps only to private securitization exposures held by an investment fund that limits its holdings of private securitization exposures to 25 percent or less of the fund's total assets. Private securitization exposures held by investment funds that allow more than 25 percent in private securitized assets would not be eligible for the proposed simplified risk weights and instead would be subject to a dollar-for-dollar capital charge. This 25 percent limit on the fund's assets is designed to help prevent banking organizations from arbitraging the proposed risk-based capital requirements for higher-risk exposures. For example, a banking organization might directly hold high-risk securitization exposures, or it might indirectly hold such exposures by investing in a fund composed entirely of those same securitization exposures. The 25 percent fund asset limit would prevent a banking organization from obtaining more favorable capital treatment by indirectly holding higher-risk securitization exposures through an investment fund concentrated in those assets than by directly holding those same securitization exposures.

The Associations' alternative proposed approach would ensure that banking organizations "do not receive a punitive risk-based capital requirement for equity exposures to investment funds that hold only low-risk assets"[122] by capping the risk weight at 100 percent for investment-grade securitizations and 400 percent for non-investment-grade securitizations. At the same time, this approach would "prevent banking organizations from arbitraging the proposed risk-based capital requirements for certain high-risk exposures"[123] by limiting the amount of private securitizations a fund may hold. The Associations believe that this approach strikes an appropriate balance and strongly urge the Agencies to adopt it in any re-proposal of the Standardized Approach NPR.

The Associations note that the same problems discussed above arise under the investment fund provisions in the equity section of the Advanced Approaches NPR.[124] The Associations believe that the same changes described above should be made to the corresponding sections of the Advanced Approaches NPR.

[122] Standardized Approach NPR at 52,927.

[123] *Id.*

[124] *See* Advanced Approaches NPR § 154.

## Schedule 1 to Annex B

## I. Proposed Categorization of Certain Residential Mortgage Exposures

The Associations recognize that poor underwriting and other problems in the residential mortgage market significantly contributed to the most recent financial crisis. The Associations also appreciate the Agencies' attempts to address these concerns by revising the risk-based capital framework for residential mortgages. However, the proposed changes in the Standardized Approach NPR would hurt, rather than help, the residential mortgage market because they do not accurately reflect the actual risk of certain types of residential mortgage loans and, as a result, create perverse incentives for excessive risk-taking and reduce the amount of available credit for many borrowers. These problems are especially acute for the proposed treatment of adjustable and floating rate mortgages and interest-only and balloon-payment loans.

### A. Adjustable- and Floating-Rate Mortgages

The Standardized Approach NPR categorizes many traditional, prudently underwritten ARMs as category 2 mortgages despite their low risk profile and benefits for both borrowers and lenders. By assuming some of the interest rate risk of such a loan, a borrower may receive the benefit of more favorable terms on the loan as well as lower interest rates if rates stay low or decline. At the same time, borrowers often receive some protection even if interest rates increase because traditional ARMs typically cap both annual and life-of-the-loan rate increases, although these caps may differ from the proposed rules that limit increases to only 2 percent in any year (and 6 percent over the life of the loan).

Lenders benefit as well and, all things being equal, the presence of any cap increases the risk of higher rates to the lender by reducing the protection against rising rates provided by a floating-rate structure. Traditional ARMs provide lower interest rate risk to lenders, and they are much easier to hedge and hold on an institution's books than fixed-rate loans. As long as such loans are otherwise soundly underwritten, the increased risk of default associated with the possibility of increased interest rates and increased borrower payments generally is manageable and balanced (or more than balanced) by the protection against such higher rates provided to the banking organization.

While certain ARMs did cause outsized losses during the mortgage crisis, these primarily resulted from poorly underwritten teaser-rate mortgages—where borrowers were qualified for loans based on their ability to pay sharply discounted monthly payments during the teaser-rate period and not on the monthly payments that would automatically rise at the end of that period. In contrast, traditional ARMs are underwritten based on the ability to make payments at prevailing interest rates, along with some adjustment for the possibility that interest rates could rise over time. The risk of such traditional ARMs, where monthly payment increases may not occur at all, is considerably lower than the risk of teaser-rate ARMs, where sharp increases in monthly payments are certain to occur within a short period (*i.e.*, two to three years).

Rather than address the problems associated with teaser-rate ARMs, the Standardized Approach NPR broadly categorizes many traditional, prudently underwritten ARMs as category 2 by distinguishing ARMs based on initial rate terms and rate caps.[125] One issue with this approach is that it treats all ARMs with fixed-rate periods of fewer than five years as if they were teaser-rate ARMs—that is, as if maximum possible payment increases were certain to occur. For a mortgage to qualify as category 1, the lender must conclude "that the borrower is able to repay the loan using the maximum interest rate that may apply during the first five years after the date of the closing of the residential mortgage exposure transaction."[126] Using this approach, for example, an ARM with a one-year initial fixed rate of 4 percent, an annual cap on rate increases of 2 percent and a lifetime cap of rate increases of 6 percent would have to be underwritten at the outset as if it were a 10 percent mortgage rather than a 4 percent mortgage. In contrast, an ARM with a five-year initial fixed rate of 4 percent, with the same 2 percent annual cap and 6 percent lifetime cap, could be underwritten as a 4 percent mortgage. This difference—4 percent vs. 10 percent—is truly stark. Clearly, the traditional, one-year ARM has more default risk for the lender than the five-year ARM—but not nearly as much more risk as the proposed rule would require in allocated capital. At the same time, the one-year ARM provides more protection against interest rate risk to the banking organization. By assuming the worst possible outcome in all circumstances, the proposed rule is excessively conservative and will strongly deter lenders from offering traditional ARMs with shorter fixed-rate periods that some consumers will prefer (especially during periods of higher prevailing interest rates).

In addition, the proposal treats all ARMs with initial rate increases of more than 2 percent as if they were teaser-rate ARMs. This approach severely penalizes traditional ARMs currently held by banking organizations because the vast majority of outstanding ARMs are "5/2/5" mortgages. A 5/2/5 mortgage is one in which the interest rate may increase up to 5 percent in the first adjustment period and up to 2 percent in any subsequent year, but in no event may the increase be more than 5 percent over the life of the loan. In contrast, the NPR defines a category 1 mortgage as one in which the annual interest rate does not increase by more than 2 percentage points in any 12-month period and by no more than 6 percentage

[125] It is unclear whether the Agencies believe adjustable-rate mortgages are more risky than fixed-rate mortgages, given that floating-rate commercial loans receive the same risk weight as fixed-rate commercial loans.

[126] *See* Standardized Approach NPR at 52,939; *see also* Basel III Numerator NPR § ___.2 (Definitions).

points over the life of the exposure.[127] Because the interest rate on 5/2/5 ARMs may increase by up to 5 percent in the first adjustment period—but by no more than 5 percent over the life of the loan—all such ARMs would be category 2 mortgages under the proposal. This retroactive change to the treatment of a staple product in the U.S. mortgage industry is wholly inappropriate, especially given that the 5 percent lifetime cap on a 5/2/5 mortgage is *lower* than the proposed 6 percent lifetime cap for category 1 mortgages, and given that the higher initial rate on a 5/2/5 mortgage *reduces* interest rate risk to the banking organization.

Additionally, given that virtually all HELOCs are indexed to the prime rate with no cap for rate increases, the proposed 2 percent annual cap would automatically cause these exposures to be considered category 2 mortgages, no matter how conservatively underwritten. This treatment of HELOCs is inappropriate. Such floating-rate assets provide meaningful interest rate risk management protection to banking organizations, and the proposed automatic category 2 treatment would require banking organizations to significantly increase pricing on these exposures to compensate for lower amounts of interest rate risk protection. Furthermore, the proposed treatment of floating-rate mortgages would allow a borrower to control the timing and amount of subsequent draws on HELOCs at a capped rate. A banking organization cannot effectively hedge against these risks given the revolving nature of a HELOC.[128] Thus, the proposed 2 percent annual cap is yet another example of an intuitive, overly conservative and non-quantitative view being applied to an overly broad group of exposures, with significant adverse consequences.

Any re-proposal of the Standardized Approach NPR should not automatically treat residential mortgage exposures as category 2 loans if the rate can rise more than 2 percent in the first adjustment period, especially for loans extended prior to the rule's adoption. While a more modest adjustment based on a careful evaluation of the balance between payment risk and interest rate risk may be appropriate, the overly conservative standard in the proposed rule is not. Additionally, without more empirical evidence to calibrate the marginal increased risk from traditional ARMs with shorter fixed-rate periods, any re-proposal should eliminate the overly conservative requirement to underwrite to the maximum possible interest rate increase.

If the intent is to require additional risk-based capital for particularly volatile products such as negative amortization ARMs or teaser-based structures, this goal could be addressed through much more targeted and narrowly focused risk-weighting categories. One way to achieve this goal, for example, is to categorize all ARMs with an initial rate that is

[127] *See* Standardized Approach NPR at 52,939.

[128] Providing such an option, which would be exercisable purely at the borrower's discretion, would be risky and expensive, particularly in environments where rates are likely to rise. Banking organizations would have to charge borrowers for such an option, which they may not even desire—particularly not at the price necessary to justify the service.

significantly below the market rate as a category 2 mortgage. ARMs generally have initial rates that are slightly below the market rate in order to encourage the borrower to share some of the interest rate risk with the lender. However, ARMs with initial rates that are significantly below market potentially set up the borrower for payment shock at the first adjustment period. For instance, the rate on a 2/28 ARM with a 3 percent initial rate in a 5 percent rate environment will almost certainly increase after the initial adjustment period. Any re-proposal of the Standardized Approach NPR should target these types of riskier, teaser-rate ARMs rather than broadly bringing other types of prudently underwritten ARMs into the category 2 designation. The Associations believe that these suggested approaches more clearly distinguish the risks of teaser-rate ARMs from traditional ARMs.

To the extent that an ARM is penalized as a high-risk category 2 loan due to its contractual initial rate cap, a banking organization should be able to reclassify the loan after the initial adjustment period. For example, a 5/2/5 mortgage would meet the category 1 requirement for a 2 percent annual cap and a 6 percent lifetime cap after the initial adjustment period. A 5/2/5 mortgage that otherwise meets all the characteristics of a category 1 loan therefore should be reclassified as a category 1 loan in the year after the first adjustment period.

The Associations also urge the Agencies to evaluate research and data from previous periods of rapidly rising interest rates to calibrate and determine whether any capital charges are warranted, with a balanced view of risk to banks from payment shock and interest rate risk. The Associations are not aware of a period where a heightened risk of payment default related to ARMs outweighed the protection provided by ARMs relative to fixed-rate or more tightly capped products. In fact, to the extent that there was an observable period of rapidly rising rates (*e.g.*, the early 1980s), the risk to depository institutions and to capital seems to have derived primarily from fixed-rate mortgage portfolios. Likewise, the Agencies recently expressed heightened concern regarding the interest rate risks associated with bank holdings of fixed-rate assets.

For all the reasons outlined above, it is critical to get the proposed residential mortgage rules right. The Associations believe that the suggested approaches more clearly distinguish the risks of teaser-rate ARMs from traditional ARMs, but also emphasize that additional empirical research is necessary. The very clear guidance provided by the Federal Reserve Board regarding its intentions and expectations for interest rate policy for the next three years also suggests that there is time to perform a comprehensive empirical study and get this right. Therefore, the Associations request that the Agencies withdraw the current Standardized Approach NPR and take the time to study and consider re-proposing the risk weight rules for adjustable-rate mortgages.

## B. Interest-Only and Balloon-Payment Mortgages

Under the Standardized Approach NPR, interest-only and balloon-payment mortgages are deemed to be category 2 mortgages. The Agencies also solicited comments on whether the proposal appropriately addresses loans with balloon payments or interest-only features.[129] The Associations believe that this broad treatment of all interest-only and balloon-payment mortgages as high-risk category 2 mortgages is inappropriate.

An example illustrates an issue with the proposed treatment of all interest-only mortgages as high-risk category 2 loans. Examining the improvement in collateralization due to principal amortization, and assuming a 30-year amortization, a starting LTV of 80 percent and an interest rate of 5 percent, an exposure's LTV would decline over the first seven years to 70 percent—and, under the Standardized Approach NPR, the risk weight for the mortgage would be 50 percent. (Historically, the overwhelming majority of mortgages are refinanced or otherwise repaid within seven years.) In contrast, a comparable 80 percent LTV mortgage that defers principal repayment—an interest-only mortgage—would have only a marginally higher LTV ratio at the end of that seven-year period—still 80 percent—but the risk weight requirement for the interest-only mortgage would be 100 percent, or twice as high. The Associations strongly believe that the data do not show that this type of interest-only mortgage is twice as risky as a comparable amortizing mortgage.[130]

With respect to exposures that result in a balloon payment, the Associations acknowledge the possible liquidity event for a borrower presented by very short-term balloon structures during periods of high volatility in property values (*e.g.*, within three years from origination). However, lumping these short-term balloon structures with longer-term balloon structures is inappropriate. Longer-term balloon structures are less risky because property values should or may well stabilize after such time (*e.g.*, 10 years from origination), and the borrower would have sufficient time to manage the foreseeable liquidity event.[131]

Accordingly, lumping all interest-only and balloon-payment mortgages into category 2, along with high-risk negative-amortization and teaser-rate mortgages, is unwarranted. Such a policy would have the effect of discouraging banking organizations from offering any

[129] Standardized Approach NPR, Question 5.

[130] Some members of the Associations indicate that their interest-only mortgage portfolios outperform their more traditional mortgage portfolios, demonstrating that underwriting rather than loan structure better characterizes the risk and appropriateness of these mortgage loans.

[131] The proposed exemption for certain balloon mortgages in rural locations in the Qualified Mortgage NPR further demonstrates that balloon structures are not inherently risky. *See* Federal Reserve Board, *Regulation Z; Truth in Lending*, 76 Fed. Reg. 27,390 (May 11, 2011). The Associations believe that, with appropriate underwriting, balloon mortgages may be made in locales other than rural ones in a safe and sound manner.

of the former types of mortgages, notwithstanding demand in the marketplace. Without any empirical evidence to support the substantially higher risk weights applied to such mortgages, the capital rule should not substitute the government's judgment for the borrower's in determining the type of loan that best serves his or her needs.

## II. Effects of Proposed Treatment of Junior-Lien Mortgages

The Associations recognize that junior-lien mortgages generally present greater risks than first-lien mortgages and should be risk-weighted accordingly. However, the proposed treatment of junior-lien mortgages goes too far by categorizing almost all junior-lien mortgages as category 2 mortgages. This approach does not recognize the differences in risk among various types of junior-lien mortgages and, as a result, imposes a punitive capital charge on certain types of less risky junior liens. Moreover, the proposed risk weights for junior-lien mortgages are too high when compared with other types of collateralized and non-collateralized loans.

### A. Proposal Fails to Distinguish Among Different Types of Junior Liens

A fundamental problem with many junior-lien mortgages that were extended pre-crisis was that they often allowed borrowers to extract *all* the equity in a home, effectively constituting a mortgage with a CLTV ratio of 100 percent or greater. That problem should be addressed in the rule by focusing on appropriate CLTV levels, not by treating virtually all junior liens as category 2 mortgages regardless of CLTV levels. Indeed, where the CLTV ratio for a junior lien is significantly below 100 percent, that lien would truly be secured. Yet the proposed rule fails to explain why such secured exposures would nevertheless be assigned higher risk weights than general unsecured credit, and it provides no empirical data to support this proposition. Truly collateralized exposures, even junior-lien exposures, are generally less risky (and at the portfolio level were demonstrated during the crisis to be less risky) than non-collateralized credit; they should receive a correspondingly lower risk weight.

The Standardized Approach NPR fails to distinguish among various types of junior liens with substantially different risk profiles. A recent study by the Federal Reserve Bank of New York presented data suggesting that wholesale classification of varied types of junior-lien mortgages as category 2 exposures is inappropriate.[132] This study showed that lenders provided HELOCs primarily to higher-quality borrower and underwrote the loans to the credit quality of the borrower and not just the value of the home.[133] These HELOCs generally

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[132] *See* Donghoon Lee, Christopher Mayer and Joseph Tracy, Federal Reserve Bank of New York, *A New Look at Second Liens* (Staff Report No. 569, Aug. 2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr569.pdf.

[133] *Id.* at 3, 6-7, 11-12.

performed consistently with prime mortgage exposures.[134] By contrast, closed-end junior liens originated simultaneously with a first lien (so-called "piggyback" mortgages) often were originated to borrowers with low credit scores to lower the borrower's initial down payment.[135] These piggyback, closed-end mortgages generally performed in line with non-prime exposures.[136] Based on the risk characteristics presented in this report, HELOCs originated after the first lien, or not used for financing purposes, should receive lower risk weights than closed-end junior liens originated and funded simultaneously with the first lien.

### B. Proposed Risk Weights Are Too High and Overstate Risk

The large majority of junior-lien mortgages, which by definition are secured, will be deemed category 2 mortgages with risk weights of 100 percent to 200 percent. Although banking organizations suffered substantial unexpected losses from home equity loans and lines of credit during the financial crisis, such losses represented a historical aberration that was compounded by weak underwriting standards that have since been corrected—and that will continue to be reinforced by other regulatory requirements, such as those relating to "qualified mortgages" and "qualified residential mortgages." Thus, the high risk weights for junior-lien mortgages are unwarranted.

### C. "Tainting" of First-Lien Mortgages by Second-Lien Mortgages Is Unwarranted

The excessive risk weights for junior-lien mortgages become more apparent when viewed in light of risk-weighted assets ("**RWAs**") and the marginal risk weight of a junior-lien loan. An example illustrates this point: Assume a banking organization originates a $5,000 category 2 junior-lien mortgage on a $100,000 property, in addition to a $50,000 category 1 first-lien mortgage on the same property. The RWA amount for the initial $50,000 category 1 first lien loan is $17,500.[137] The addition of a $5,000 category 2 second lien loan to the first lien dramatically increases the RWA amount to $55,000, with $50,000 of the additional RWA being ascribed to the first lien (versus $17,500 without considering the second lien).[138] The difference between the two—$32,500, plus the $5,000 from making the second lien—is the marginal increase in RWA caused by extending the $5,000 second lien.

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[134] *Id.*

[135] *Id.* at 6, 11-12.

[136] *Id.* at 11-12. Similarly, the report presented data suggesting that the simultaneous origination of first and second liens in "bubble markets" accounted for a significant amount of additional risk during the recent real estate boom. *Id.* at 6, 13-14.

[137] 0.35 x $50,000 = $17,500.

[138] 1.00 x $55,000 = $55,000.

Put another way, the effective marginal risk weight for this $5,000 junior lien is *750 percent.*[139] Note that if the same second lien were provided by another lender, the addition to that bank's RWA would only be the $5,000 generated through the second lien, at the proposed 100 percent risk-weighting.

The proposed high marginal risk weights are particularly troublesome because they discourage banking organizations from holding both junior and senior liens on the same property given the ability of a small junior lien to cause an entire exposure to cross to a higher risk weight, either by moving to a higher LTV ratio or moving to category 2, or both.

The Associations strongly believe that this effect on an institution's first-lien mortgage, caused simply by the institution having made the second lien itself (rather than another institution doing so), is unwarranted and not related to any inherent difference in risk. If the treatment of junior liens is not adjusted in any re-proposal of the Standardized Approach NPR, there is a genuine concern that the new capital regime would seriously impair the ability of banking organizations to profitably offer second-lien loans to customers. Such a result would not only create further challenges for banking organizations of all sizes, but also reduce access to such credit for a wide swath of borrowers throughout the country.

[139] (55,000 – 17,500) / 5,000 = 7.50.

# ANNEX C

## Advanced Approaches NPR: Comments and Recommendations

The largest and most internationally active U.S. banking organizations ("**advanced approaches banking organizations**"), as a whole, represent a sizable portion of the U.S. financial sector and compete globally with other internationally active banks and financial institutions. They also account for a significant portion of the overall lending, credit facilitation and financial intermediation activity in the United States and thus play an important role in facilitating a robust U.S. economic recovery.

Many aspects of the Agencies' proposals (such as the treatment of cleared transactions and exposures to CCP default funds, capital deductions for investments in unconsolidated financial institutions and revisions to the securitization framework) would have a disproportionately burdensome impact on advanced approaches banking organizations due to their size, their international presence and the diverse range of banking and financial services they provide to individuals, businesses and governments. Other aspects of the proposals (such as the countercyclical capital buffer, supplementary leverage ratio and credit valuation adjustment capital charge) would apply only to advanced approaches banking organizations. In contrast to other U.S. banking organizations, advanced approaches banking organizations would be subject to *all three* NPRs and would need to calculate their risk-weighted assets under both the Standardized Approach NPR and the Advanced Approaches NPR under the Agencies' interpretation of the Collins Amendment. Accordingly, in addition to the Associations' comments and recommendations regarding the Advanced Approaches NPR that are discussed below, advanced approaches banking organizations also strongly support the comments and recommendations set forth in the Basel III Numerator and Standardized Approach sections of the letter, particularly the following:

- Unrealized gains and losses on AFS securities should not be allowed to "flow through" to CET1.

- With respect to proposed deductions for investments in unconsolidated financial institutions, the definition of "financial institution" should be narrowed by *excluding*, among others, Volcker covered funds, commodity pools and certain other investment funds, and ERISA plans. In addition, the "predominantly engaged in financial activities" prong of the Agencies' proposed definition of "financial institution" should be limited to financial companies designated as systemically important by the FSOC, which are by definition predominantly engaged in financial activities.

- Technical adjustments must be made to the proposed eligibility criteria for CET1 capital, Additional Tier 1 capital and Tier 2 capital. Without these technical changes, existing common stock issued by U.S. banking organizations may not fully satisfy the criteria for Common Equity Tier 1; existing preferred stock may not fully satisfy the criteria for Additional Tier 1 capital; and existing trust preferred securities may not fully satisfy the criteria for Tier 2 capital.

- Consistent with International Basel III, the Agencies should carefully review and calibrate the supplementary leverage ratio before imposing it as a formal requirement on advanced approaches banking organizations.
- Under the standardized approach, exposures to securities firms that meet certain comparability requirements should be treated in the same manner as exposures to depository institutions, *i.e.*, assigned a 20 percent risk weight.
- Consistent with the international Basel capital framework, the standardized approach should permit the use of the IMM to determine the exposure amount for OTC derivative contracts.
- In the standardized approach, the 50 percent risk weight ceiling for exposures to OTC derivative contracts should be retained for any banking organization that does not use the IMM as a permitted alternative to the CEM (as recommended above).

## I. Changes to Holding Periods and Margin Periods of Risk under the Counterparty Credit Risk Framework

The existing advanced approaches rules provide a number of EAD-based methodologies that a banking organization may use instead of a loss given default ("**LGD**") estimation methodology to recognize the benefits of financial collateral in mitigating the counterparty credit risk associated with repo-style transactions, eligible margin loans and collateralized OTC derivatives.[1] For purposes of taking into account potential fluctuations in the market value of such collateral, the collateral haircut approach (for both standard supervisory haircuts and banking organizations' own internal estimates for haircuts) and the simple VaR methodology generally assume a ten-business-day holding period for OTC derivatives, eligible margin loans and netting sets of such transactions and a five-business-day holding period for repo-style transactions and nettings sets thereof. Under the IMM, a banking organization may, with supervisory approval, include the effect of a collateral

[1] These methodologies include (i) the collateral haircut approach (available for certain collateralized OTC derivatives, eligible margin loans, repo-style transactions and single-product netting sets of such transactions); (ii) the simple VaR methodology (available only for single-product netting sets of eligible margin loans and repo-style transactions); and (iii) the IMM (available for collateralized OTC derivatives, eligible margin loans, repo-style transactions as well as cross-product and single-product netting sets of such transactions).

agreement within its internal model used to calculate EAD and may set EAD equal to the expected exposure at the end of the "margin period of risk."[2] The minimum margin period of risk is five business days for repo-style transactions that are subject to daily re-margining and daily marking-to-market and 10 business days for other transactions when liquid financial collateral is posted under a daily margin maintenance requirement.[3]

The Advanced Approaches NPR makes a number of changes to the assumed holding periods for collateral and margin periods of risk. As proposed, a banking organization must assume a holding period of 20 business days under the collateral haircut approach or simple VaR methodology[4] or must assume a margin period of risk under the IMM of 20 business days for netting sets if (i) the number of trades exceeds 5,000 at any time during the quarter (unless the counterparty is a CCP or the netting set consists of cleared transactions with a clearing member); (ii) *one* or more trades involve illiquid collateral posted by the counterparty; or (iii) the netting set includes *any* OTC derivatives that cannot be easily replaced.[5]

Moreover, if over the two previous quarters more than two margin disputes[6] on a netting set have occurred that lasted longer than the holding period or margin period of risk

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[2] With respect to a netting set subject to a collateral agreement, the margin period of risk means the time period from the most recent exchange of collateral with a counterparty until the next required exchange of collateral plus the period of time required to sell and realize the proceeds of the least liquid collateral that can be delivered under the terms of the collateral agreement and, where applicable, the period of time required to re-hedge the resulting market risk, upon the default of the counterparty.

[3] Under the existing advanced approaches rules, a banking organization that can model EPE without collateral agreements (but cannot achieve the higher level of modeling sophistication to model EPE with collateral agreements) can set effective EPE for a collateralized netting set by using an approach that includes an add-on reflecting the potential increase in exposure of the netting set over the margin period of risk, which is five business days for repo-style transactions subject to daily re-margining and daily marking-to-market and 10 business days for other transactions when liquid financial collateral is posted under a daily margin maintenance requirement.

[4] Under the square root of time formula, doubling the holding period for OTC derivatives, eligible margin loans and netting sets of such transactions from 10 business days to 20 business days would effectively result in a more than 41 percent increase in the applicable collateral haircut. This is because the square root of the number 2 (doubling) is approximately 1.41. Likewise, quadrupling the holding period for repo-style transactions from five business days to 20 business days would result in a 100 percent increase in the applicable collateral haircut. This is because the square root of the number 4 (quadrupling) is 2.

[5] The Agencies note that, for purposes of determining whether collateral is illiquid or whether an OTC derivative cannot be easily replaced for these purposes, a banking organization could, for example, assess whether, during a period of stressed market conditions, it could obtain multiple price quotes within two days or less for the collateral or OTC derivative that would not move the market or represent a market discount (in the case of collateral) or a premium (in the case of an OTC derivative).

[6] According to the Agencies, margin disputes occur when the banking organization and its counterparty do not agree on the value of collateral or on the eligibility of the collateral provided. In addition, such disputes

*(continued)*

used in the EAD calculation, a banking organization would be required to use a holding period or a margin period of risk for that netting set that is at least *twice* the minimum period that would otherwise be used for that netting set.

While these proposed amendments are consistent with the provisions in International Basel III, the Associations believe that mechanically applying these new requirements to increase the minimum holding period or margin period of risk for an entire netting set, without regard to whether the assumed problems can have a material impact on the netting set at issue, would be like using the proverbial sledgehammer to crack a nut. Such an approach is inconsistent with what is supposed to be the more sophisticated risk-sensitivity of the advanced approaches.

The Associations recommend that advanced approaches banking organizations be allowed to apply a materiality standard in determining whether or not to increase the minimum holding period or margin period of risk on the occurrence of any of the assumed problems. For example, when the number of trades exceeds 5,000, a banking organization should be able to determine that, if the number of trades exceeded 5,000 by an insignificant number for only two or three days in the quarter, and the collateral was highly liquid and easy to value, there would be no need to assume a longer holding period or margin period of risk.[7] Alternatively, in such a situation, a banking organization should be permitted to increase the period by one or more business days, but not required to increase it to the full 20 business days.[8]

Similarly, the Associations do not support the notion that the existence of a *single* trade that is secured by illiquid collateral or a *single* OTC derivative that cannot be easily replaced should taint the entire netting set. The Associations believe that, rather than being required to impose a 20-business-day holding period or margin period of risk on the entire netting set, advanced approaches banking organizations should be permitted to assess the materiality of the impact of the amount of illiquid collateral or the OTC derivatives that cannot easily be replaced on the relevant netting set. If the impact is immaterial (for example,

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also can occur when a banking organization and its counterparty disagree on the amount of margin that is required, which could result from differences in the valuation of a transaction or from errors in the calculation of the net exposure of a portfolio (for instance, if a transaction is incorrectly included or excluded from the portfolio).

[7] Should the Agencies decide not to introduce a materiality threshold with respect to the 5,000 trades trigger, they should, at a minimum, allow the number of trades in a netting set to be determined using the average number of trades within a quarter instead of "at any time during a quarter."

[8] The Agencies should also clarify that the phrase "number of trades in a netting set exceeds 5,000" refers to market-facing trades rather than any allocations at the level of the client. This clarification would be particularly relevant for a banking organization that acts as an agent lender of securities, where a single market-facing transaction or trade may be allocated among numerous clients.

if the value of the illiquid collateral represented 1 percent or less of the value of the collateral securing the netting set or is otherwise of limited significance), the banking organization could determine not to increase the holding period or margin period of risk or else to increase it in a manner that reflects the limited extent of the expected impact (for example, by one or two business days).

In addition, the Agencies should clarify in the rule text that an advanced approaches banking organization may assess the liquidity of collateral by product category based on long-term liquidity data observed by the banking organization. Such an approach would be preferable to requiring banking organizations to dynamically determine the liquid or illiquid status of collateral on a "live" or daily basis. Making determinations on a live or daily basis would introduce volatility in such determinations, could lead to a significant level of confusion among market participants and could have a destabilizing effect on the funding markets.

The same materiality approach should apply to margin disputes. While margin disputes should be taken into account in determining the appropriate holding period or margin period of risk, the Associations believe that a banking organization should be able to exclude immaterial margin disputes (*e.g.*, certain disputes that are driven by the fact that counterparties use different internal valuation methodologies) for purposes of determining whether more than two margin disputes have taken place over the two previous quarters. An advanced approaches banking organization should be permitted to establish its own materiality thresholds based on its prior experience in handling margin disputes and by taking into account factors such as whether the root cause of the dispute has been addressed and the likelihood that a dispute with respect to a particular netting set will recur.

## II. Capital Requirement for Credit Valuation Adjustment

### A. Consistent with International Basel III, the CVA Capital Requirement Should Be Calculated on a Portfolio Basis and Not on a Counterparty-by-Counterparty Basis

Under International Basel III, a banking organization must calculate its capital requirement for credit valuation adjustment ("**CVA capital requirement**") on a portfolio basis with respect to all OTC derivative counterparties.[9] In contrast, the Advanced

[9] Specifically. International Basel III provides that a banking organization using the advanced CVA approach "must calculate this additional capital charge by modeling the impact of changes in the counterparties' credit spreads on the CVAs of all OTC derivative counterparties, together with eligible CVA hedges." *See* International Basel III at ¶ 98. Similarly, International Basel III provides that a banking organization using the standardized CVA approach must "calculate a portfolio capital charge using the [supervisory] formula." International Basel III at ¶ 104.

Approaches NPR provides that "total CVA risk-weighted assets is the *sum* of the CVA capital requirement, $K_{CVA}$, calculated for *each* of a [banking organization]'s OTC derivative counterparties, multiplied by 12.5."[10] The Advanced Approaches NPR therefore departs from International Basel III by requiring an advanced approaches banking organization to calculate a separate CVA capital charge for each OTC derivative counterparty and to aggregate those amounts for purposes of determining its "total CVA risk-weighted assets." In the preamble to the Advanced Approaches NPR, the Agencies did not address or provide an explanation for this departure from International Basel III. The Associations believe that U.S. implementation of the CVA capital requirement should be consistent with International Basel III to promote harmonized capital standards across jurisdictions.

### B. Clarify That Certain Purchased CDS Hedges Are Not Subject to CVA Capital Requirement

The Basel Committee's frequently asked questions regarding International Basel III's revisions to the counterparty credit risk framework clarify that the CVA capital requirement does not apply to a purchased credit default swap ("**CDS**") that hedges a banking book position where the banking book position is itself not subject to the CVA capital requirement.[11] Section ___.132(c)(3) of the Advanced Approaches NPR appears to provide for a similar outcome by stating:

> "Notwithstanding paragraphs (c)(1) and (c)(2) of this section: (i) A [banking organization] that purchases a credit derivative that is recognized . . . as a credit risk mitigant for an exposure that is not a covered position under [the Market Risk Final Rule] is not required to calculate a separate counterparty credit risk capital requirement under this section so long as the [banking organization] does so consistently for all such credit derivatives and either includes or excludes all such credit derivatives that are subject to a master netting agreement from any measure used to determine counterparty credit risk exposure to all relevant counterparties for risk-based capital purposes."

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[10] Advanced Approaches NPR §___.132 (c)(4) (emphasis added).

[11] Basel Committee, *Basel III Counterparty Credit Risk - Frequently Asked Questions*, Question 2.3 (July 2012), *available at* http://www.bis.org/publ/bcbs228.pdf ("[Question:] How should purchased credit derivative protection against a banking book exposure that is subject to the double default framework (paragraph 307(i)) or the substitution approach (paragraphs 140-142) be treated in the context of the CVA capital charge? [Response:] Purchased credit derivative protection against a banking book exposure that is subject to the double default framework [paragraph 307(i)] or the substitution approach (paragraphs 140-142) and where the banking book exposure itself is not subject to the CVA charge, will also not enter the CVA charge. This purchased credit derivative protection may not be recognised as hedge for any other exposure. (This is consistent with Annex 4 paragraph 7 that says that the EAD for counterparty credit risk from such instruments is zero. It is also consistent in the sense that hedging should not increase the capital charge.)").

For the avoidance of doubt, the Agencies should confirm that, notwithstanding the specific references to "paragraphs (c)(1) and (c)(2)," Section ___.132(c)(3) would also exempt the purchased CDS from the CVA capital requirement in Section ___.132(e) of the Advanced Approaches NPR in a manner consistent with the Basel Committee's FAQs.

### C. Exclude OTC Derivatives with Central Banks, Multilateral Development Banks and Similar Counterparties from CVA Capital Requirement

The Associations believe that the CVA capital requirement should not apply to OTC derivatives with central banks (such as the Federal Reserve Banks), multilateral development banks ("**MDBs**") and similar counterparties that have very low credit risk. Such an exclusion would be consistent with the zero percent risk weight (reduced from the current 20 percent) that would apply to exposures to MDBs, the Bank for International Settlements and the European Central Bank under the Standardized Approach NPR. In the Standardized Approach NPR, the Agencies stated that assigning a zero percent risk weight to exposures to MDBs "is appropriate in light of the generally high-credit quality of MDBs, their strong shareholder support, and a shareholder structure comprised of a significant proportion of sovereign entities with strong creditworthiness."[12] For similar reasons, the Market Risk Final Rule also permits a banking organization that uses a standardized method to calculate specific risk capital requirements to assign a zero specific risk-weighting factor to a debt position that is an exposure to an MDB.[13] Likewise, under both the current and proposed advanced approaches rules, exposures to MDBs are exempt from the 0.03 percent PD floor.[14]

## III. Capital Treatment of Cleared Transactions and Default Fund Exposures

The Associations' comments and recommendations regarding the proposed capital treatment of cleared transactions and exposures to the default funds of CCPs, set forth in the Standardized Approach NPR section of this letter, are equally applicable to the substantively identical provisions in the Advanced Approaches NPR. In fact, due to the volume of their derivatives activities and their prominent role in the global derivatives market, U.S. advanced approaches banking organizations would likely be disproportionately affected by the Agencies' proposed capital framework for cleared transactions and exposures to the default funds of CCPs.

The highly competitive nature of the global derivatives marketplace makes it critical that the framework adopted by the Agencies does not place the U.S. banking sector and the U.S. derivatives markets at a competitive disadvantage. Moreover, many advanced

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[12] Standardized Approach NPR at 52,896.

[13] Market Risk Final Rule § 10(b)(2)(ii).

[14] *See, e.g.*, 12 C.F.R. Part 225, Appendix G, § 31(d)(2).

approaches banking organizations are clearing members of multiple CCPs and provide clearing services to their clients. For these clearing member banking organizations, it is important that the U.S. capital framework provides appropriate incentives—and *not* disincentives—for the clearing of client transactions. In this respect, the Associations strongly urge the Agencies to continue to work with the Basel Committee to further align international and domestic bank capital rules with the G-20 commitment towards the central clearing of standardized derivatives products.

### A. Capital Treatment for Cleared Credit Derivatives

Under the Advanced Approaches NPR, as under the existing advanced approaches rules, a banking organization may elect to recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative covering a wholesale exposure (other than a securitization exposure) by using the PD substitution approach, the LGD adjustment approach or, if the transaction qualifies, the double default treatment. Under the PD substitution approach, a banking organization may recognize the guarantee or credit derivative in determining its risk-based capital requirement for the hedged exposure by substituting the PD associated with the rating grade of the protection provider for the PD associated with the rating grade of the obligor.

In the proposals, the Agencies recognized that "CCPs help improve the safety and soundness of the derivatives market" and generally assigned a 2 percent risk weight to trade exposures to a QCCP.[15] The Agencies should clarify that, if a wholesale exposure is hedged using a credit derivative that is cleared through a QCCP, a banking organization would similarly be permitted to apply a 2 percent risk weight to the hedged portion of that exposure, instead of using the "PD associated with the rating grade of the protection provider."

## IV. Proposed Changes to Securitization Framework

### A. Definition of "Securitization"

As discussed above in the Standardized Approach NPR section of this letter, the Associations believe that the proposed definition of "securitization exposure" is overly broad. For the reasons set forth in that section, the Associations recommend that the definition focus on the tranching as well as the pooling of risk because the credit risk associated with a securitization position depends on both factors. The proposed definition of securitization exposure also includes any exposure that "directly or indirectly references" a securitization exposure. As discussed above, the Associations believe that the "directly or indirectly references" standard is ambiguous and requires clarification.

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[15] Standardized Approach NPR at 52,904.

Even if the Agencies are not prepared at this time to revisit the definition of "securitization exposure," they should, at a minimum, clarify that transactions that are not traditionally considered securitizations would not be "securitization exposures." Among other things, the Agencies should clarify that the provision of non-tranched guarantees, whether they cover all or only a *pro rata* portion of the obligations of the obligor on the reference exposure, and similar non-tranched credit protection[16] would not be treated as securitization exposures. This clarification would be consistent with both the existing and the proposed U.S. advanced approaches capital frameworks.[17] Regardless of which definition of "securitization exposure" the Agencies ultimately adopt, the Associations encourage the Agencies to provide clear guidance regarding the practical scope and application of such definition.

### B. Definition of "Resecuritization"

As discussed above in the Standardized Approach NPR section of this letter, the Associations believe that the Agencies should exempt from the overly broad definition of "resecuritization" (i) *de minimis* resecuritizations in which less than 5 percent of the underlying exposures are securitization positions; and (ii) resecuritizations involving a senior tranche of a single underlying security.

### C. Availability of Data Inputs for SFA

The revised securitization framework under the Advanced Approaches NPR would remove the ratings-based approach and internal assessment approach for securitization exposures. The hierarchy of approaches would be modified such that a banking organization would be required to deduct from CET1 any after-tax gain-on-sale resulting from a securitization and apply a 1,250 percent risk weight to the portion of a CEIO that does not constitute after-tax gain-on-sale. If a securitization exposure does not require deduction, a banking organization would be required to assign a risk weight to the securitization exposure using the SFA. If a banking organization cannot apply the SFA because not all the relevant

[16] *See, e.g.*, Letter from Robert W. Strand, American Bankers Association, to Anna Lee Hewko, Federal Reserve Board; Amrit Sekhon, OCC; and Jason Cave, FDIC (Aug. 22, 2012), *available at* http://www.aba.com/Issues/LetterstoCongress/Documents/LetteronCommercialLoanswithLimitedGuaranteesasSyntheticSecuritization.pdf (arguing that limited guarantees (*i.e.*, guarantees covering losses up to a certain limit) of commercial and industrial loans and CRE loans should not automatically be treated as synthetic securitizations).

[17] *See, e.g.*, 12 C.F.R. Part 225, Appendix G, § 2 ("Examples of a wholesale exposure include: (1) A *non-tranched* guarantee issued by a bank holding company on behalf of a company."); Advanced Approaches NPR § ___.134(a) (Proposed provisions on recognition of guarantees and credit derivatives apply to wholesale exposures for which "(i) Credit risk is fully covered by an eligible guarantee or eligible credit derivative; or (ii) Credit risk is covered on a *pro rata* basis (that is, on a basis in which the [banking organization] and the protection provider share losses proportionately) by an eligible guarantee or eligible credit derivative.").

qualification criteria are met, the Advanced Approaches NPR would allow the banking organization to apply the SSFA. However, the Agencies stated in the preamble to the Advanced Approaches NPR that they expect banking organizations to use the SFA rather than the SSFA "in all instances where data to calculate the SFA is available."[18] The Advanced Approaches NPR further requires that a banking organization be able to "explain and justify (*e.g.*, based on data availability) to its primary federal regulator any instances in which the banking organization uses the SSFA rather than the SFA for its securitization exposures."

The Associations are concerned that, to the extent that a banking organization experiences difficulties in obtaining data required to use the SFA (for example, in the case of certain non-U.S. securitizations), those difficulties would preclude it from using the SFA. The proposed hierarchy of approaches, under which the inability to use the SFA requires the use of the SSFA or a 1,250 percent risk weight, implies the need for some degree of leeway, in the form of a materiality threshold, before any such difficulty should be deemed serious enough to preclude the use of the SFA. Where there are immaterial gaps in the data required to use the SFA, the Agencies should permit a banking organization to use proxy data, provided it represents a conservative estimate of actual data. This approach is consistent with the principle of conservatism, which permits a banking organization "not to apply an aspect of the [advanced approaches rules] for cost or regulatory burden reasons, if the result would be a more conservative capital requirement."[19] If and when actual data becomes available to fill these immaterial data gaps, an advanced approaches banking organization would replace the proxy data with actual data inputs for purposes of the SFA.

While the Associations acknowledge that the SSFA is a less draconian alternative to the use of the SFA than a deduction or a 1,250 percent risk weight, the Associations submit that the Agencies' stated expectation that advanced approaches banking organizations should use the SFA will be met on a consistent basis if proxy data can be used to bridge immaterial gaps in the availability of data.

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[18] Advanced Approaches NPR at 52.991.

[19] In the preamble to the final rule implementing the existing advanced approaches capital framework, the Agencies made the following remarks regarding the principle of conservatism: "Several commenters asked whether it would be permissible not to apply an aspect of the rule for cost or regulatory burden reasons, if the result would be a more conservative capital requirement. For example, for purposes of the [ratings-based approach] for securitization exposures, some commenters asked whether a bank *could choose not to track the seniority of a securitization exposure and, instead, assume that the exposure is not a senior securitization exposure*. . . . The agencies believe that in some cases it may be reasonable to allow a bank to implement a simplified capital calculation if the result is more conservative than would result from a comprehensive application of the rule." (emphasis added). *See* OCC, Federal Reserve Board, FDIC and OTS, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework — Basel II*. 72 Fed. Reg. 69,288, 69,299-300 (Dec. 7, 2007) (emphasis added) ("**U.S. Basel II Advanced Approaches Final Rule**").

### D. Modifications to the SSFA

The Associations' comments and recommendations regarding the SSFA, set forth in the Standardized Approach NPR section of this letter, apply equally to the substantively identical SSFA provisions in the Advanced Approaches NPR. These recommended modifications to the SSFA are important to all U.S. banking organizations, including advanced approaches banking organizations, which would use the SSFA to calculate their capital floor as well as in situations where they are not able to use the SFA.

The Associations also request that the Agencies correct a technical error in the Advanced Approaches NPR rule text. Specifically, the proposed rule text specifies that one of the parameters for the SSFA, $K_G$, "is the weighted-average (with unpaid principal used as the weight for each exposure) total capital requirement of the underlying exposures calculated using **this subpart**."[20] The Associations request that the Agencies correct the reference to "this subpart" by replacing it with "subpart D"—*i.e.*, the Standardized Approach NPR—to make it clear that $K_G$ would be calculated using the risk-weighting methodologies under the Standardized Approach NPR and *not* the Advanced Approaches NPR.[21] This correction would be consistent with the Agencies' description of $K_G$ in the preamble to the Advanced Approaches NPR: "A banking organization would need several inputs to calculate the SSFA. 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 directly by the banking organization."[22]

### E. Risk Weight Floor under the SFA

The Advanced Approaches NPR would revise the existing SFA formula to impose a 20 percent risk weight floor for securitization exposures subject to the SFA. Currently, the SFA imposes a 7 percent risk weight floor on securitization exposures, which is consistent with the international Basel capital framework.[23] This 7 percent risk weight floor is introduced via a 56-basis-point multiplier in the SFA formula, which, as the Agencies

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[20] Advanced Approaches NPR § ___.144(b)(1).

[21] As noted further below in this letter, the Associations request that the Agencies clarify in the Advanced Approaches final rule text that, prior to the effective date of any Standardized Approach final rule, references to "subpart D" would be treated as references to the risk weights set forth in the existing Basel I-based capital rules.

[22] Advanced Approaches NPR at 52,991. *See* Market Risk Final Rule § 11(b)(1) (Definition of $K_G$). *See* also Standardized Approach NPR at 52,919.

[23] Basel Committee, *Enhancements to the Basel II Framework*, 3 (Jul 2009), *available at* http://www.bis.org/publ/bcbs157.pdf ("[T]he SFA floor risk weight is set at 20% for resecuritisation exposures. *It remains at 7% for other securitisation exposures.*" (emphasis added)).

explained in the preamble to the final rule implementing the existing advanced approaches capital framework, is the product of a 7 percent risk weight floor and an 8 percent minimum total capital requirement.[24] In a departure from the international Basel capital framework, the Advanced Approaches NPR would increase this multiplier from 56 basis points to 160 basis points—*i.e.*, the product of a 20 percent risk weight floor and an 8 percent minimum total capital requirement.[25] The Associations believe that the Agencies should retain the 56-basis-point multiplier / 7 percent risk weight floor in the SFA to ensure consistency with international capital standards.

### F. Replace 1,250 Percent Risk Weight with Maximum Risk Weights that Correspond with Phased-in Increases in Required Capital Ratios

The Advanced Approaches NPR contemplates that if a banking organization does not, or is not able to, apply the SFA or the SSFA to a securitization exposure, it would generally be required to assign to the exposure a 1,250 percent risk weight (the inverse of the 8 percent minimum total capital requirement under the 1988 Basel capital accord).

As discussed in the Standardized Approach NPR section of this letter, the Associations believe that the proposed 1,250 percent risk weight for certain securitization and other exposures is inappropriate because it would require banking organizations with a total capital to total risk-weighted assets ratio of greater than 8 percent to hold more than a dollar of capital for every dollar of securitization exposure. This would be the case under the Basel III Numerator NPR, which, over time, would require banking organizations to maintain a total capital to total risk-weighted assets ratio of at least 10.5 percent (minimum required capital ratio plus capital conservation buffer) to avoid limitations on capital distributions and discretionary bonus payments to executive officers. The Associations therefore request the Agencies to adopt the Transitional Arrangements for Maximum Risk Weights set forth in **Table B-1** of the Standardized Approach NPR section of this letter. Under this approach, the required capital for certain exposures would be equal to but would not exceed the value of the underlying asset.

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[24] *See* U.S. Basel II Advanced Approaches Final Rule at 69,368 ("The SFA formula effectively imposes a 56 basis point minimum risk-based capital requirement (8 percent of the 7 percent risk weight) per dollar of securitization exposure. Although such a floor may impose a capital requirement that is too high for some securitization exposures, the agencies continue to believe that some minimum prudential capital requirement is appropriate in the securitization context. This 7 percent risk weight floor is also consistent with the lowest capital requirement available under the RBA and, thus, should reduce incentives for regulatory capital arbitrage.").

[25] *See* Advanced Approaches NPR § ___.143(c).

### G. Clarify Due Diligence Requirements for Securitization Exposures

The Associations' comments and recommendations regarding the proposed due diligence requirements in the Standardized Approach NPR section of this letter apply equally to the substantively identical due diligence provisions in the Advanced Approaches NPR.

In addition, consistent with the increased sophistication and risk-sensitivity of the advanced approaches capital framework and its reliance on a banking organization's internal risk assessments and processes, the Agencies should permit an advanced approaches banking organization to make a reasonable materiality assessment in the event that it is not able to obtain all of the necessary information to satisfy each due diligence item prior to acquisition of the exposure and, in any event, within three business days. If the advanced approaches banking organization is otherwise satisfied that it has a comprehensive understanding of the securitization exposure and that the missing data are not material to such an understanding, it should not be disqualified from showing that it has satisfied the due diligence requirement.

The Associations note that the proposed due diligence provisions would require a banking organization to (i) initially "conduct an analysis of the risk characteristics of a securitization exposure *prior to acquiring the exposure*, and document such analysis within three business days after acquiring the exposure"; and (ii) "on an on-going basis (no less frequently than quarterly), evaluate, review, and update as appropriate *the analysis required under this section* for each securitization position."[26] It is clear from the rule text that the requirement to perform an initial analysis of the securitization exposure "*prior to* acquiring the exposure" would not apply retroactively to acquisitions made before the effective date of the due diligence requirement. Logically, the proposed requirement to periodically evaluate, review and update *that initial analysis* would also not apply to securitization exposures acquired before the effective date of the due diligence requirement. The Agencies should confirm this outcome in the final advanced approaches rule text.

### H. Operational Criteria for Recognizing the Transfer of Risk

Under the operational criteria for recognizing the transfer of risk in the existing advanced approaches rules, a banking organization that transfers exposures that it has originated or purchased from a securitization special purpose entity or other third party in connection with a traditional securitization may exclude the exposures from the calculation of risk-weighted assets, provided certain conditions are met. One such condition is the requirement that the transfer be considered a sale under GAAP. The Advanced Approaches NPR would amend the existing rules to require that the transferred exposures are not reported

[26] Advanced Approaches NPR § ___.141(c)(2).

on the banking organization's balance sheet under GAAP. The Agencies believe that recent changes to GAAP necessitate this proposed change.

The Associations note that whether an item is on-balance sheet or off-balance sheet under GAAP has no direct bearing on whether the banking organization has effectively transferred away the credit risk associated with the item. More generally, the Associations believe that the operational criteria for recognizing transfer of risk should focus on the economic reality of a transfer and not on how it would be classified under GAAP or other accounting principles, which are subject to change. In this respect, the existing requirement that the banking organization must have "transferred to third parties credit risk associated with the underlying exposures" should be sufficient to focus the operational criteria on the economic reality of a transaction. Accordingly, the Associations believe that the Agencies should either remove the proposed requirement that the transferred exposures are not reported on a banking organization's balance sheet under GAAP or else provide that the operational criteria may be met, even if the exposure remains on the balance sheet under GAAP, as long as the banking organization has otherwise satisfied the criteria of transferring the associated credit exposure to a third party.

## V. Other Proposed Changes in the Advanced Approaches NPR

### A. Definition of Advanced Approaches Banking Organization

Under the existing advanced approaches rules, a banking organization must adopt an implementation plan and complete a satisfactory parallel run before it may use the advanced approaches to calculate its risk-based capital requirements.[27] This requirement is also reflected in Section ___.121(c) of the Advanced Approaches NPR, which states that "[b]efore determining its risk-weighted assets under this subpart and following adoption of the implementation plan, the [banking organization] must conduct a satisfactory parallel run." However, other provisions in the Agencies' proposals, when read together, appear to suggest that a banking organization would be required to calculate its risk-weighted assets under the advanced approaches even before adopting an implementation plan or completing a parallel run, *i.e.*, merely by meeting the proposed definition of "advanced approaches [banking organization]." Specifically, Section ___.2 of the Basel III Numerator NPR defines "advanced approaches [banking organization]" as "a [banking organization] that is described in §___.100(b)(1) of subpart E," which section merely describes the types of banking organizations that would be subject to the advanced approaches provisions without reference to a successful completion of the parallel run. Section ___.10 of the Basel III Numerator NPR goes on to require an "advanced approaches [banking organization]" (as defined) to calculate its regulatory capital ratios using both its advanced approaches total risk-weighted

[27] *See, e.g.*, 12 C.F.R. Part 225. Appendix G, § 21.

assets and its standardized total risk-weighted assets and to use the lower of the two sets of ratios to determine whether it has satisfied its minimum capital requirements. When read together, Sections ___.2 and ___.10 of the Basel III Numerator NPR appear to require a banking organization that has not even adopted an implementation plan or completed a parallel run to use the advanced approaches to calculate its risk-based capital requirements—an outcome that would be at odds with Section ___.121(c) of the Advanced Approaches NPR and the existing advanced approaches rules.

The Associations request that the Agencies clarify in the final rule text that a banking organization would not be required to determine its risk-weighted assets under the advanced approaches prior to adopting an implementation plan and completing a satisfactory parallel run. This clarification can be achieved by amending the definition of "advanced approaches [banking organization]" in Section ___.2 of the Basel III Numerator NPR.

The Advanced Approaches NPR also provides that an advanced approaches banking organization will remain subject to the advanced approaches rule until its primary federal supervisor determines that application of the rule would not be appropriate in light of the banking organization's asset size, level of complexity, risk profile or scope of operations. The stated rationale for this provision is to prevent banking organizations being able to "move in and out of the scope of the advanced approaches rule based on fluctuating asset sizes."[28] The Associations believe that a banking organization whose consolidated total assets and foreign exposures fall below the applicable thresholds should be permitted, at its own choosing, to exit the advanced approaches rule. The Associations further believe that the Agencies' concern about "fluctuating asset sizes" could be addressed by requiring a banking organization to remain under the applicable thresholds for a certain number of consecutive quarters before being able to exit the advanced approaches rule. Just as a banking organization can manage its size and foreign exposures to avoid becoming subject to the advanced approaches rule, the Agencies should not unduly impede the ability of a banking organization to exit the advanced approaches in an orderly fashion by reducing its size and foreign exposures.

### B. Asset Value Correlation Multiplier for Certain Exposures

Under the Advanced Approaches NPR, banking organizations would apply a multiplier of 1.25 to the asset value correlation ("**AVC**") factor for wholesale exposures to unregulated financial institutions, regardless of their asset size. In addition, banking organizations would apply a 1.25 AVC multiplier for wholesale exposures to regulated financial institutions with consolidated assets of $100 billion or more.

[28] Advanced Approaches NPR at 52,993.

In light of ongoing industry and regulatory developments, particularly those under the Dodd-Frank Act that are aimed at reducing the interconnectedness among systemically important financial institutions, such as the single counterparty exposure limits, the Associations believe that the Agencies should reconsider the necessity of introducing in the United States any multiplier to the AVC factor. In any event, the Associations believe that a uniform 1.25 multiplier is a blunt tool that fails to take into account the quality of financial institution counterparties. Should the Agencies decide to implement an AVC multiplier in the United States, they should, at a minimum, provide for a range of multipliers (*e.g.*, from 1.00 to 1.25) that depend on a variety of qualitative and quantitative factors, including the financial institution's levels of capitalization and leverage and its overall risk profile. For example, in the case of a regulated financial institution that exceeds its minimum capital (and, if applicable, leverage) requirements, the Associations believe that it would be entirely appropriate to apply a lower multiplier than 1.25. If the whole point of requiring more capital is to enable financial institutions to better withstand losses from credit, market and other risks, it seems counterintuitive not to recognize that virtue in calibrating an AVC factor multiplier.

An institution's risk profile should also be taken into account in determining the appropriate multiplier. Not all financial institutions, whether regulated or not, present the same risks. For example, an unregulated financial institution that operates primarily as a third-party asset manager may not present the same level of risk as an unregulated financial institution that primarily takes long-term principal risk. Forcing advanced approaches banking organizations to apply the same multiplier without permitting them to make reasonable distinctions among the risks posed by different financial institutions is an approach completely at odds with what is supposed to be the more sophisticated, risk-sensitive nature of the advanced approaches.

### 1. Definition of "Financial Institution" and "Regulated Financial Institution"

Notwithstanding the foregoing, should the Agencies decide to implement an AVC multiplier in the United States, they should, at a minimum, address the definition of "financial institution" as used in that context. As proposed, the AVC multiplier applies to wholesale exposures to "financial institutions"—both regulated and unregulated. As discussed in the Basel III Numerator NPR portion of this letter, the Associations believe that the proposed definition of "financial institution" is overly broad. The Associations recommend that, for purposes of all three NPRs, the definition should be limited to the following entities: (i) insured depository institutions (including banks, thrifts and credit unions); (ii) depository institution holding companies (including BHCs and SLHCs); (iii) non-bank financial companies designated by the FSOC under Section 113 of the Dodd-Frank Act (which by definition includes entities that are "predominantly engaged" in financial activities); (iv) insurance companies; (v) securities holding companies (as defined in Section 618 of the

Dodd-Frank Act); (vi) foreign banks; (vii) securities firms (including U.S. broker-dealers); (viii) futures commission merchants; and (ix) swap dealers and security-based swap dealers. Under the Associations' definition, the following entities, among others, would not be included in the definition of "financial institution": (i) Volcker Rule covered funds and other funds that register under, or rely on exemptions from, the Investment Company Act of 1940; (ii) commodity pools; and (iii) ERISA plans.

Should the definition of "financial institution" be revised along the lines suggested by the Associations, the Agencies should also make a conforming revision to the definition of "*regulated* financial institution." Specifically, the term "regulated financial institution" should be revised to include a parent company and its subsidiaries where any substantial legal entity in the consolidated group is either (i) a U.S.-domiciled "financial institution" (as defined); or (ii) a non-U.S. domiciled "financial institution" that is subject to consolidated supervision and regulation comparable to that imposed on a U.S.-domiciled financial institution. This definition would better align the definition of "regulated financial institution" with the definition of "financial institution" recommended by the Associations and would retain the comparability standard set forth in the Agencies' proposed definition of "regulated financial institution."[29] The concept that the regulated status of a consolidated group depends on the regulated status of a substantial legal entity within the group is based on paragraph 102 of International Basel III.[30] Adopting this approach in the United States would ensure greater consistency with international capital standards.

However, should the Agencies decide not to revise the overly broad definition of "financial institution" set forth in their proposals, the Associations believe that the Agencies should, at a minimum, make the following revision to the proposed definition of "*regulated* financial institution":

> "Regulated financial institution means a parent company and its subsidiaries where any substantial legal entity in the consolidated group is a financial institution subject to consolidated supervision and regulation comparable to that imposed on the following U.S. financial institutions: depository institutions, depository institution holding companies, nonbank financial companies supervised by the Board, designated financial market utilities, securities broker-dealers, credit unions, ~~or~~ insurance companies, commodity

[29] Basel III Numerator NPR § ___.2 (Definitions).

[30] International Basel III at ¶ 102 ("For the purpose of this paragraph, a regulated financial institution is defined as a parent and its subsidiaries where any substantial legal entity in the consolidated group is supervised by a regulator that imposes prudential requirements consistent with international norms. These include, but are not limited to, prudentially regulated Insurance Companies, Broker/Dealers, Banks, Thrifts and Futures Commission Merchants.").

trading advisors, futures commission merchants, introducing brokers, major swap participants, major security-based swap participants, registered investment advisers, registered investment companies, swap dealers, or security-based swap dealers."

This revised definition, like the one originally proposed by the Agencies, would allow domestic and international institutions (to the extent that they are captured by the definition of "financial institution") to be considered "*regulated* financial institutions" if they are regulated in a comparable manner to certain U.S. financial institutions. Notably, the revision recommended by the Associations would expand the list of enumerated U.S. financial institutions to capture a broader range of regulated financial institutions.

### 2. Revision to Proposed Formula for Determining the Correlation Factor (R)

If the Agencies ultimately decide to implement an AVC multiplier in the United States, they should also address a technical issue with the proposed formula for determining the Correlation Factor (R) for wholesale exposures to unregulated financial institutions and regulated financial institutions with total assets of $100 billion or more. Under the Advanced Approaches NPR, the formula is as follows:

$R = 1.25\times(0.12+0.18\times e^{-50\times PD})$

Notably, the mathematical expression in the parentheses is $(0.12+\mathbf{0.18}\times e^{-50\times PD})$, which is the Correlation Factor formula for HVCRE exposures, as opposed to $(0.12+\mathbf{0.12}\times e^{-50\times PD})$, the Correlation Factor formula for non-HVCRE wholesale exposures. The Agencies have not provided any justification in the preamble to the Advanced Approaches NPR for increasing the coefficient of $e^{-50\times PD}$ from 0.12 to 0.18, which would be in addition to the proposed 1.25 multiplier. Increasing the coefficient from 0.12 to 0.18 (an increase of 50 percent) would result in a materially higher correlation factor for wholesale exposures to unregulated financial institutions and certain regulated financial institutions.[31] It would also amount to a significant departure from International Basel III and would have adverse competitive consequences for the U.S. banking system. Specifically, under International Basel III, the 1.25 multiplier is applied to the correlation formula for general wholesale exposures as opposed to the correlation formula for HVCRE exposures.[32] Accordingly, should an AVC

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[31] Quantitatively, the difference between $1.25\times(0.12+0.18\times e^{-50\times PD})$ and $1.25\times(0.12+0.12\times e^{-50\times PD})$ is $0.075\times e^{-50\times PD}$.

[32] Under International Basel III, the correlation formula for exposures to unregulated and certain regulated financial institutions, which includes a 1.25 multiplier, is expressed as: Correlation (R_FI) = 1.25 x [0.12 x (1 - EXP(-50 x PD)) / (1 - EXP(-50))+ **0.24** x [1 - (1 - EXP(-50xPD)) / (1 - EXP(-50))]]. The correlation formula for exposures to corporates, sovereigns and bank (wholesale exposures) is: Correlation (R) = 0.12 × (1

*(continued)*

multiplier be introduced in the United States, the Associations request that the multiplier be applied to the formula for non-HVCRE wholesale exposures, *i.e.*, ($0.12+\mathbf{0.12}\times e^{-50\times PD}$).

### C. Collateral Haircut Approach

The existing advanced approaches rules provide a number of EAD-based methodologies that a banking organization may use instead of an LGD estimation methodology to recognize the benefits of financial collateral in mitigating the counterparty credit risk associated with repo-style transactions, eligible margin loans and collateralized OTC derivatives. In particular, the collateral haircut approach permits a banking organization to apply standard supervisory market price volatility haircuts to take into account the potential fluctuations in the market value of collateral. Under the existing advanced approaches rules, the haircut applicable to collateral in the form of a debt security depends on the type of issuer, the residual maturity on the instrument and whether the instrument falls within the two highest investment-grade rating categories (a haircut ranging from 1 percent to 8 percent), the two lowest investment-grade rating categories (a haircut ranging from 2 percent to 12 percent) or one rating category below investment-grade (a 25 percent haircut).

In contrast, under the Agencies' proposals, collateral in the form of debt securities issued by "non-sovereign issuers that receive a 100 percent risk weight" under the Standardized Approach NPR—*i.e.*, *all* corporate issuers—would be subject to a 25 percent haircut, regardless of the residual maturity of the instrument. A 25 percent haircut corresponds to the haircut that currently applies to corporate debt securities falling within one rating category *below* investment-grade.[33] Yet the proposed definition of "financial collateral" for purposes of the collateral haircut approach includes only debt securities that are "investment grade." The Associations respectfully submit that it is illogical to apply the existing below-investment-grade haircut to collateral that is, by definition, investment-grade. Not only does the proposed 25 percent haircut represent a departure from the existing advanced approaches rules and International Basel II, but it is also inconsistent with the Agencies' proposed collateral haircuts for other types of instruments, which generally take into account residual maturity.

In light of the fact that the proposed definition of "financial collateral" includes only debt securities that are "investment-grade," the Agencies should limit the maximum haircut

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– EXP(-50 × PD)) / (1 – EXP(-50)) + **0.24** × [1 – (1 – EXP(-50 × PD)) / (1 – EXP(-50))]. By contrast, the correlation formula for HVCRE exposures is: Correlation (R) = 0.12 x (1 – EXP(-50 x PD)) / (1 – EXP(-50)) + **0.30** x [1 – (1 – EXP(-50 x PD)) / (1 – EXP(-50))]. *Compare* International Basel III ¶ 102 *with* International Basel II ¶ 283.

[33] *See, e.g.*, 12 C.F.R. Part 225. Appendix G. § 32(b)(2)(ii), Table 3 - Standard Supervisory Market Price Volatility Haircuts.

applicable to collateral issued by all "non-sovereign issuers that receive a 100 percent risk weight" to 12 percent. A maximum haircut of 12 percent corresponds to the maximum haircut that currently applies to debt securities falling within the two lowest investment-grade rating categories and thus represents a conservative approach. In addition, the Agencies should assign a lower haircut for collateral in the form of an investment-grade corporate debt security that has a shorter residual maturity. For example, the Agencies should consider assigning a 3 percent haircut to such collateral where the residual maturity is less than one year, a 6 percent haircut where the residual maturity is more than one year but less than or equal to five years and a 12 percent haircut where the residual maturity is greater than five years. With the exception of a higher haircut for collateral with residual maturity of less than one year, in order to reflect more recent historical volatility data, these haircut amounts correspond to the existing haircuts that apply to debt securities falling within the two lowest investment-grade rating categories and thus also represent a conservative approach. This approach would also result in a greater alignment of U.S. bank capital rules with the international Basel capital framework, which generally assigns smaller supervisory haircuts to collateral that is above investment-grade and that has a lower residual maturity.[34]

### D. Proposed Definition of "Eligible Guarantee"

Under the existing advanced approaches rules, a banking organization may take into account the risk-reducing effects of "eligible guarantees" in support of a wholesale exposure. While a guarantee must satisfy certain criteria to qualify as an "eligible guarantee," the existing advanced approaches rules generally do not impose limits on the types of persons that could provide "eligible guarantees."[35] The existing U.S. approach is consistent with the international Basel capital framework, which generally states that "there are no limits to the

[34] *See* International Basel II at ¶ 151.

[35] There are two exceptions to the general rule under the existing advanced approaches provisions. First, for purposes of the double default treatment, a hedged exposure must, among other things, be provided by an "eligible double default guarantor." Second, the existing operational criteria for synthetic securitizations provide that a banking organization may recognize, for risk-based capital purposes, the use of a credit risk mitigant to hedge underlying exposures if, among other things, the credit risk mitigant is an eligible credit derivative or eligible guarantee provided by an "eligible securitization guarantor." Eligible securitization guarantor is defined as (1) a sovereign entity, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank, a depository institution, a bank holding company, a savings and loan holding company provided all or substantially all of the holding company's activities are permissible for a financial holding company under 12 U.S.C. 1843(k), a foreign bank, or a securities firm; (2) any other entity (other than a securitization SPE) that has issued and outstanding an unsecured long-term debt security without credit enhancement that has a long-term applicable external rating in one of the three highest investment-grade rating categories; or (3) any other entity (other than a securitization SPE) that has a PD assigned by the bank holding company that is lower than or equal to the PD associated with a long-term external rating in the third-highest investment-grade rating category.

range of eligible guarantors [under the advanced approach] although the set of minimum requirements . . . concerning the type of guarantee must be satisfied."[36] In contrast, the Advanced Approaches NPR would introduce an "eligible guarantor" requirement to the definition of "eligible guarantee." Consequently, with respect to *all* wholesale exposures—and not only for purposes of the operational criteria for synthetic securitizations—a banking organization may recognize the credit risk mitigation benefits of a guarantee only if it is provided by an "eligible guarantor." The Agencies did not provide any justification for this significant departure from the existing advanced approaches rules, except to state that they are "proposing to replace the term 'eligible securitization guarantor' with the term 'eligible guarantor.'"[37]

As proposed, "eligible guarantor" would be limited to (i) a sovereign, the Bank for International Settlements, the International Monetary Fund, the European Central Bank, the European Commission, a Federal Home Loan Bank, Federal Agricultural Mortgage Corporation (Farmer Mac), a multilateral development bank, a depository institution, a BHC, an SLHC, a credit union, or a foreign bank; and (ii) an entity (other than a special purpose entity) (1) that at the time the guarantee is issued, or anytime thereafter, has issued and outstanding an unsecured debt security without credit enhancement that is investment-grade; (2) whose creditworthiness is not positively correlated with the credit risk of the exposures for which it has provided guarantees; and (3) that is not an insurance company engaged predominantly in the business of providing credit protection (such as a monoline bond insurer or re-insurer). Under this definition, any person that is not enumerated in the first prong of the definition must satisfy the qualitative criteria set forth in the second prong to be an "eligible guarantor."

The proposed definition of "eligible guarantor" would significantly narrow, without any apparent justification and in a U.S. departure from the international Basel capital framework, the types of persons whose guarantees a banking organization could recognize for credit risk mitigation purposes under the risk-based capital framework.

First, the proposed requirement that a guarantor has issued and outstanding an unsecured debt security without credit enhancement that is "investment-grade" is at odds with the advanced approach under the international Basel capital framework, which does not require a guarantor to have an external rating of any kind, much less any particular level of rating.[38] As a result, imposing an investment-grade requirement, which is the approach the

[36] International Basel II at ¶ 307. An exception to this general proposition is that the double default framework under International Basel II requires the entity selling credit protection to satisfy certain criteria. *See* International Basel II at ¶ 307(ii).

[37] Advanced Approaches NPR at 52,989.

[38] *See* International Basel II at ¶ 307.

Agencies have taken to comply with Section 939A of the Dodd-Frank Act, is wholly misplaced: There is no external rating reference to replace in the first place.

Second, the proposed requirement that an entity's creditworthiness not be "positively correlated with the credit risk of the exposures for which it has provided guarantees"—read literally—could exclude any guarantor that is not expressly enumerated in the first prong of the "eligible guarantor" definition and would effectively eliminate the ability to rely on a parent's guarantee of a subsidiary's obligations. This is because, as the risk of default increases on exposures that a person has guaranteed, the guarantor's own risk of default tends to increase as well.

International Basel III does not mandate such a radical narrowing of the definition of eligible guarantee. Moreover, to the extent that a positive correlation between the credit risk of the original obligor and the guarantor would give rise to a higher PD of the guarantor or a higher LGD, this increased risk would already be taken into account *quantitatively* under the PD substitution approach or the LGD adjustment approach. Accordingly, introducing a *qualitative* requirement related to such correlation is duplicative and unnecessary. In the absence of an international consensus and any clearly articulated justification for this qualitative requirement, the Associations recommend that the positive correlation requirement either be deleted altogether or at the very least be modified to require a substantially high or "excessive" degree of positive correlation before disqualifying the relevant guarantor.[39] Without such an amendment, and taking into account the proposed AVC factor multiplier for financial institutions, as well as the exposure risk-shifting mechanism of the proposed Dodd-Frank Act Section 165 single counterparty exposure limits, the Associations question whether banking organizations will effectively be able to recognize the credit risk mitigating benefits of guarantees going forward.

Finally, the Agencies should clarify that, for purposes of assessing whether an insurance company is "engaged predominantly in the business of providing credit protection," the term "engaged predominantly" should have the same meaning as the term "predominantly engaged" (*i.e.*, the 85 percent or more gross revenue and total asset tests) in the proposed definition of "financial institution." The Agencies should also clarify that they do not mean to equate *all* re-insurers with insurance companies that are engaged predominantly in the business of providing credit protection, as could otherwise be inferred from the third prong of the definition: "(iii) that is not an insurance company engaged predominantly in the business

[39] In this respect, the Associations note that, under the international Basel capital framework, one of the eligibility requirements for the double default framework—but not for the PD substitution approach or the LGD adjustment approach—is that "[t]here [be] no *excessive correlation* between the creditworthiness of a protection provider and the obligor of the underlying exposure due to their performance being dependent on common factors beyond the systematic risk factor." International Basel II at ¶ 307(ii)(k) (emphasis added).

of providing credit protection (such as a monoline bond insurer or re-insurer)." The Associations note that many re-insurers are not predominantly engaged in providing credit protection, but reinsure casualty and other risks. The predominantly engaged test should stand on its own and the parenthetical examples should be deleted as they are both superfluous and potentially confusing.

### E. Trade-Related Letters of Credit

The existing advanced approaches rules provide that an exposure's effective maturity must be no greater than five years and no less than one year, except that an exposure's effective maturity must be no less than one day if the exposure has an original maturity of less than one year and is not part of a banking organization's "ongoing financing of the obligor."[40] The Agencies have stated that "short-term self-liquidating trade finance exposures" are examples of transactions that would qualify for the "ongoing financing of the obligor" exemption from the one-year maturity floor.[41] In 2011, the Basel Committee revised the advanced internal ratings-based approach under International Basel II to specifically exempt trade finance instruments from the one-year maturity floor.[42] The Advanced Approaches NPR reflects this revision to the international Basel capital framework by introducing an additional exemption from the one-year maturity floor for trade-related letters of credit.[43] The Associations request confirmation that, under the Advanced Approaches NPR, as under the existing advanced approaches rules, short-term self-liquidating trade finance instruments would continue to be exempt from the one-year maturity floor.[44] Such confirmation would be consistent with the Agencies' existing approach and the 2011 revisions to International Basel II and would provide greater certainty to banking organizations and market participants that engage in trade finance.

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[40] *See, e.g.*, 12 C.F.R. Part 225, Appendix G, § 31(d)(7).

[41] *See* U.S. Basel II Advanced Approaches Final Rule at 69,333 ("Examples of transactions that may qualify for the exemption from the one-year maturity floor include amounts due from other banks, including deposits in other banks; bankers' acceptances; sovereign exposures; *short-term self-liquidating trade finance exposures*; repo-style transactions; eligible margin loans; unsettled trades and other exposures resulting from payment and settlement processes; and collateralized OTC derivative contracts subject to daily remargining.") (emphasis added); *see also* Letter from the Federal Reserve Board and OCC to Donna K. Alexander, Bankers' Association for Finance and Trade (June 7, 2010).

[42] Basel Committee, *Treatment of Trade Finance under the Basel Capital Framework* (Oct. 2011), *available at* http://www.bis.org/publ/bcbs205.pdf.

[43] Advanced Approaches NPR § ___.131(d)(7).

[44] *See* Basel Committee, *Treatment of Trade Finance under the Basel Capital Framework* at 4 ("The Committee further agreed to include, in the revised [exception for the one-year maturity floor], issued as well as confirmed letters of credit which are short term (ie have a maturity below one year) and self-liquidating.").

### F. Treatment of Private Securitization Exposures Held by Investment Funds

As described in detail in the Standardized Approach NPR section of this letter, both the Standardized Approach NPR and the Advanced Approaches NPR would effectively impose a 1,250 percent risk weight on private securitization exposures (*i.e.*, securitization exposures that are not guaranteed by a government agency or GSE) held by an investment fund, regardless of the actual risk of the exposures. That section of the letter sets forth an alternative approach that caps the risk weight applicable to private securitization exposures held by investment funds that limit their holdings of non-government, non-GSE securitizations to 25 percent or less of the fund's assets. The Associations believe that the Agencies should also incorporate this simpler approach for private securitization exposures held by certain eligible investment funds into the advanced approaches capital framework.

### G. References to Subpart D (Standardized Approach) and the Effective Date of Subpart D

Under the Basel III Numerator NPR, advanced banking organizations would calculate their risk-based capital floors using the risk weights and methodologies set forth in the Standardized Approach NPR. In addition, certain aspects of the Advanced Approaches NPR refer to "subpart D," *i.e.*, the Standardized Approach NPR. Assuming the Basel III Numerator final rule or the Advanced Approaches final rule becomes effective *prior* to the effective date of any Standardized Approach final rule, the Agencies should clarify how the three sets of rules would interact.

Section ___.10(c) of the Basel III Numerator NPR states that an advanced approaches banking organization's CET1 capital ratio is the lower of (i) the ratio of its CET1 capital to its "standardized total risk-weighted assets" and (ii) the ratio of its CET1 capital to its "advanced approaches total risk-weighted assets." There are parallel provisions for determining an advanced approaches banking organization's Tier 1 and total capital ratios. Significantly, Section ___.2 of the Basel III Numerator NPR defines "standardized total risk-weighted assets" by reference to "subpart D."[45] The Agencies should clarify in the Basel III Numerator final rule that, prior to the effective date of subpart D, advanced approaches banking organizations would continue to calculate their "standardized total risk-weighted assets" using the risk weights and methodologies set forth in the existing Basel I-based capital rules.[46]

[45] *See also* Basel III Numerator NPR § ___.1(c)(3) ("Each [banking organization] must use the methodologies in subpart D (and subpart F for a market risk [banking organization]) to calculate standardized total risk-weighted assets.").

[46] *See, e.g.*, 12 C.F.R. Part 225, Appendix A.

The Agencies should also address references to subpart D in the Advanced Approaches NPR. For example, Section ___.121(c) of the Advanced Approaches NPR states that, during the parallel run period, a banking organization's "minimum risk-based capital ratios are determined as set forth in subpart D of this part." There are also references to subpart D in the proposed merger and acquisition transitional arrangement provisions. Likewise, Section ___.133(c)(3)(ii) of the Advanced Approaches NPR states: "For a cleared transaction with a CCP that is not a QCCP, a clearing member [banking organization] must apply the risk weight applicable to the CCP according to §___.32 of subpart D of this part." The provisions relating to equity exposures to investment funds also make a number of references to the risk weights in subpart D. Specifically, the Simple Modified Look-Through Approach provisions refer to "the highest risk weight assigned according to subpart D that applies to any exposure the fund is permitted to hold," and the Alternative Modified Look-Through Approach provisions refer to the "risk weight categories assigned according to subpart D."[47] The Agencies should clarify in the final rule text that, prior to the effective date of any Standardized Approach final rule, these references to subpart D would be treated as references to the risk weights set forth in the existing Basel I-based capital rules.

## VI. Trading Book / Banking Book Boundary Issues Resulting from the Market Risk Final Rule

Effective January 1, 2013, the Market Risk Final Rule narrows the definition of "covered position" for purposes of the trading book. For example, whereas the current market risk rule defines covered position to include all positions in a market risk banking organization's trading account (as reported on the banking organization's Call Report or FR Y-9C), regardless of whether they are held with intent to trade,[48] the Market Risk Final Rule modifies the definition of covered position to focus on whether the position is held with such intent and to specifically exclude certain positions such as non-publicly traded equity positions.[49] As a consequence, a number of trading positions that are currently subject to the market risk capital rule will become subject to the standardized approach or advanced approaches risk-based capital rules, as applicable. Accordingly, in finalizing the standardized approach and advanced approaches risk-based capital rules, the Agencies should carefully consider the implications of applying these rules to former trading book positions in order to ensure that the capital treatment is appropriate.

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[47] *See* Advanced Approaches NPR § ___.154(c) and (d).

[48] *See, e.g.*, 12 C.F.R. Part 225, Appendix E, § 2(a).

[49] Under the Market Risk Final Rule, the definition of "covered position" includes a trading asset or trading liability that is a "trading position or hedges another covered position." "Trading position," in turn, means a position that is held by the banking organization "for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits."

One example of a trading book / banking book boundary issue that results from the narrower definition of covered position in the Market Risk Final Rule relates to the treatment of non-publicly traded equity positions. The existing market risk capital rules permit a banking organization to use a VaR model that takes into account the hedging or offsetting characteristics of a pair of non-publicly traded equity positions in the trading book. However, non-publicly traded equity positions such as private fund investments will no longer be considered covered positions under the Market Risk Final Rule. Accordingly, such positions will be subject to the banking book risk-based capital rules beginning on January 1, 2013. The banking book risk-based capital rules do not permit two non-publicly traded equity exposures to form a "hedge pair" for purposes of calculating the capital charge for equity exposures. Specifically, under both the Simple Risk Weight Approach and the Internal Models Approach for equity exposures, "hedge pair" is defined as two equity exposures that form an effective hedge provided each equity exposure is *publicly traded* or has a return that is primarily based on a *publicly traded* equity exposure. In light of the fact that all non-publicly traded equity positions will be in the banking book beginning January 1, 2013, the Agencies should make appropriate adjustments to the definition of "hedge pair" so that both the standardized approach and advanced approaches risk-based capital rules properly account for two non-publicly traded equity positions that materially offset or hedge each other.

Another trading book / banking book boundary issue that results from the narrower definition of covered position relates to the treatment of financial instruments that serve as "proxy" hedges for banking book positions. Consider a banking organization that purchases a CDS on a sovereign as a proxy hedge for a loan to an entity that is supported by the sovereign. If the proxy hedge is in the trading account, it would be a covered position under the existing market risk framework and the banking organization's market risk VaR model could recognize the hedging relationship between CDS and the loan. As a result of the narrower definition of covered position in the Market Risk Final Rule, however, the proxy hedge could become a banking book position. Currently, the banking book framework recognizes a CDS as a credit risk mitigant only if, among other conditions, the CDS references the actual obligor as opposed to a proxy obligor. The CDS and the loan would therefore be treated as two unrelated exposures under the banking book capital rules, each attracting a separate capital charge. In light of the narrower definition of covered position, the Agencies should make appropriate adjustments to the recognition of credit risk mitigants so that the banking book capital rules properly account for the relationship between an exposure and its proxy hedge.[50]

[50] In this respect, the Associations note that, in its consultative document on the fundamental review of the trading book, the Basel Committee considered whether "banking book capital requirements should be adjusted" if there is an increase in the range of instruments with market risk in the banking book. Basel

*(continued)*

Committee, *Fundamental Review of the Trading Book (Consultative Document)*, 16 (May 2012). *available at* http://www.bis.org/publ/bcbs219.pdf.

# ANNEX D

## About the Associations

The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its 2 million employees. Learn more at www.aba.com.

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

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