The Clearing House
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American Securitization Forum

October 22, 2012

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551
Attention: Jennifer J. Johnson, Secretary
**Docket No. R-1442**
**RIN 7100-AD87**

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington D.C. 20429
Attention: Comments/Legal ESS
**RIN 3064-AD95, 3064-AD96, 3064-AD97**
Attention: Robert E. Feldman, Executive Secretary

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 2-3
Washington, D.C. 20219
**Docket IDs OCC-2012-0008, OCC-2012-0009, OCC-2012-0010**
**RIN 1557-AD46**

Re: Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III – Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; Standardized Approach for Risk-Weighted Assets, Market Discipline and Disclosure Requirements; Advanced Approaches Risk-Based Capital Rule, Market Risk Capital Rule

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**")[1] and the American Securitization Forum ("**ASF**" and, together with The Clearing House, the "**Associations**")[2]

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[1] Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments

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appreciate the opportunity to comment on the three joint notices of proposed rulemaking (together, the "**NPRs**") initially issued on June 7, 2012 by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**"), the Office of the Comptroller of the Currency (the "**OCC**") and the Federal Deposit Insurance Corporation (the "**FDIC**" and, together, with the Federal Reserve and the OCC, the "**Agencies**") and published in the Federal Register on August 30, 2012[3] addressing proposed changes to their regulatory capital rules. The NPRs would generally implement the capital related provisions of Basel III[4] and certain aspects of the Basel II[5] standardized approach in a manner intended to be consistent with Section 171 (the so-called "**Collins Amendment**") and Section 939A of the Dodd Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**"), as well as make related changes to the Agencies' prompt corrective action regulations.

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Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing-house, funds transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] The American Securitization Forum is a broad-based professional forum through which participants in the U.S. securitization market advocate their common interests on important legal, regulatory, and market-practice issues. ASF members include over 330 firms, including issuers, investors, servicers, financial intermediaries, rating agencies, financial guarantors, legal and accounting firms, and other professional organizations involved in securitization transactions. ASF also provides information, education, and training on a range of securitization market issues and topics through industry conferences, seminars, and similar initiatives. For more information about ASF, its members, and activities, please go to www.americansecuritization.com.

[3] Agencies, *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III – Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action*, 77 Fed. Reg. 52,792 (Aug. 30, 2012) (the "**Basel III NPR**"); Agencies, *Regulatory Capital Rules – Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements*, 77 Fed. Reg. 52,888 (Aug. 30, 2012) (the "**Standardized Approach NPR**" and the rules set forth therein, the "**Standardized Approach**"); Agencies, *Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rules; Market Risk Capital Rule*, 77 Fed. Reg. 52,978 (Aug. 30, 2012) (the "**Advanced Approaches NPR**" and the rules set forth therein, the "**Advanced Approaches**"). The NPRs would revise the Agencies' capital rules to create an integrated set of rules. References in this letter to the "**Proposed Rules**", or to particular sections of the Proposed Rules, are to that integrated set of rules and related sections.

[4] "**Basel III**", as used in this letter, refers to the Basel Committee on Banking Supervision's publications titled *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (Dec. 2010, revised June 2011) and *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring* (Dec. 2010) (the "**Basel III Liquidity Framework**"). The NPRs do not address the rules proposed by the Basel III Liquidity Framework. Accordingly, we are not specifically addressing in this letter issues raised thereby.

[5] "**Basel II**", as used in this letter, refers to the Basel Committee on Banking Supervision's comprehensive accord titled *International Convergence of Capital Measurement and Capital Standards – A Revised Framework* (June 2006, as subsequently revised).

The financial crisis made apparent that regulatory capital rules for banks[6] were among the supervisory areas, and along with liquidity practices perhaps the supervisory area, most in need of reform. The Associations have commented extensively to the Basel Committee on Banking Supervision (the "**BIS**") and the Agencies on Basel III and other aspects of reform to regulatory capital rules.[7] We confirm again, as we have in each comment letter addressing capital proposals, that our members strongly support robust capital requirements, both as to the components of regulatory capital and required minimum levels.

In considering the NPRs, we have, of course, recognized that the Agencies themselves were forced to diverge from international standards in a number of areas because of different circumstances in the United States – most important, Dodd-Frank's prohibition (in Section 939A) on U.S. regulators' use of external credit ratings in regulations, notwithstanding that international standards make extensive use of ratings, and the Collins Amendment's requirement that ratios calculated under the general approaches act as a floor for Advanced Approaches calculations in determining compliance with minimum required capital levels (exclusive of buffers). Both of these provisions are contrary to the very notion of risk sensitive capital regulation by effectively resulting in more blunt and higher capital charges arising from, for example, the treatment of securitization exposures due to Section 939A's prohibition on the use of external credit ratings and the requirement that Advanced Approaches banks calculate risk-based capital ratios using in the denominator the higher of the Standardized Approach's and Advanced Approaches' risk-weighted assets. Moreover, these divergent U.S. requirements create uncertainty and confusion for market participants, potentially impeding the ability of these banks to access domestic and international capital markets effectively. Finally, both of

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[6] We are using the term "**bank**" in this comment letter to mean both holding companies and depository institutions that are, or are proposed to become, subject to the Agencies' capital rules.

[7] *See* Letter from The Clearing House to the BIS, dated April 16, 2010, regarding the Basel III capital framework; Letter from The Clearing House to the Honorable Timothy F. Geithner, *et al.*, dated June 15, 2011, regarding the application of surcharges to systemically important financial institutions in the United States; Letter from The Clearing House and the Institute of International Bankers to the BIS, dated August 26, 2011, regarding the assessment methodology and application of surcharges to global systemically important banks; Annex A of the Letter from The Clearing House, *et al.* to the Federal Reserve, dated April 27, 2012, regarding the notice of proposed rulemaking implementing enhanced prudential standards and early remediation regulations under Sections 165 and 166 of Dodd-Frank (the "**TCH DFA Section 165 Comment Letter**"); Letter from The Clearing House to Mr. Michael S. Gibson, dated October 15, 2012, concerning, *inter alia*, the Comprehensive Capital Analysis and Review and the Federal Reserve's capital plan rules adopted in 2011 as Section 225.8 of Regulation Y (the "**Capital Plan Rule**") effectively being the binding capital constraint for U.S. banks (the "**CCAR Letter**"); and Letter from ASF to the Federal Reserve, dated April 29, 2012, regarding the notice of proposed rulemaking implementing enhanced prudential standards and early remediation regulations under Sections 165 and 166 of Dodd-Frank (the "**ASF DFA Section 165 Comment Letter**").

those provisions result in disparities between the rules applicable to U.S. banks and non-U.S. banks, generally subjecting U.S. banks to higher capital requirements than non-U.S. banks. Although there are no immediate solutions to these statutory-created discrepancies, we urge policymakers – both legislators and regulators – to continue to consider and eventually address these concerns.

Nevertheless, as discussed more fully below, we do believe there are modifications and clarifications to the Proposed Rules that the Agencies can and should make to help ameliorate the impact of the foregoing issues even in the presence of the Collins Amendment and Section 939A.

Part I of this letter is an executive summary of our comments; Part II sets forth comments on the Basel III NPR; Part III addresses several concerns that cut across the NPRs; Part IV sets forth comments on the Standardized Approach NPR; and Part V sets forth comments on the Advanced Approaches NPR. Additionally, we have included as **Annex 1** hereto a Table of Contents that lists our specific comments (and provides appropriate page number references to this comment letter).

## I. Executive Summary

The NPRs would implement the most substantial re-regulation of bank capital since the Basel I-based general risk-based capital rules were first adopted by the Agencies in 1989. They make fundamental changes for all banks to the capital components in the numerators of capital ratios, the measure of risk weighted assets in the denominators, and the calibrations (*i.e.*, the minimum percentage ratios), and they add a multiplicity of new ratios.

We are broadly supportive of the approaches taken by the Agencies in the NPRs. We agree that the Agencies should implement Basel III for U.S. banks in a manner that is consistent with international standards (including Basel III as implemented in other jurisdictions) where feasible and consistent with the actual risk of the relevant exposure(s). Accordingly, although there are aspects of the Basel III NPR and Advanced Approaches NPR implementing components of Basel III that in prior comment letters we urged be modified or rejected, we generally do not wish to re-visit in this comment letter issues on which international regulators have reached agreement. However, there are limited areas where certain aspects of the NPRs raise particular substantive concerns for our members.[8] Specifically:

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[8] The NPRs do not address the possible application of a capital surcharge to some group of U.S. banks that may be deemed to be global systemically important banks ("**G-SIBs**") or domestic systemically important banks ("**D-SIBs**"). Accordingly, we are not addressing those surcharges in this letter other than to note that we continue to feel

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- In some cases, the NPRs contain provisions that may lead to less instead of more robust capital regulation and should be revised. For example:
  - o We continue to believe that the elimination of the filter for income/loss reported in accumulated other comprehensive income ("**AOCI**", and the reversal of AOCI from capital calculations under current rules, the "**AOCI Filter**") under U.S. generally accepted accounting principles ("**U.S. GAAP**") is ill-advised because it creates inaccurate reports of actual capital strength and the volatility of capital ratios. It also negatively affects banks' ability to hedge effectively and economically interest rate risks arising out of their liabilities (including deposit liabilities) as they are inevitably forced to shorten the maturities of debt instruments in their securities portfolios and, as a result, increases systemic risk, contrary to public policy objectives.
  - o In addition, reflecting in regulatory capital increases or decreases in AOCI under U.S. GAAP resulting from unrealized accounting "gains" or "losses" weakens the effectiveness of regulatory capital ratios as a realistic, appropriate and credible measure of financial strength, effectively either understating or overstating the ratios. Recognition of (i) unrealized losses that are unlikely to be realized on highly liquid debt securities with no credit risk would effectively impose a capital charge on banks based on nothing other than interest rate movements that likely are not reflective of the entity's net interest rate exposures and (ii) unrealized gains that similarly are unlikely to be realized provides a capital benefit to banks that may be illusory. Therefore, we agree with the suggestion by the Agencies in Question 16 of the Basel III NPR that, to the extent that the AOCI Filter is retained in the final rules, the proper test for establishing a category of instruments for which the AOCI Filter will be retained is securities whose changes in fair value are predominantly

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strongly that the view we expressed in the DFA Section 165 Comment Letter is correct – namely, that for U.S. banks the interplay between stress test requirements and the Capital Plan Rule, as each has been implemented, is effectively a capital surcharge for U.S. banks having $50 billion or more in total consolidated assets, making any significant further surcharge on U.S. G-SIBs or D-SIBs inappropriate and unnecessary. Further, the NPRs do not address the application of the Capital Plan Rule to banks in light of the changes proposed in the NPRs. Accordingly, we are not addressing issues raised by the Capital Plan Rule. For a letter setting forth The Clearing House's comments on the Capital Plan Rule, see the CCAR Letter.

attributable to fluctuations in a benchmark interest rate as opposed to credit risk in order to, at least, ameliorate some of the foregoing concerns. Accordingly, the AOCI Filter should be retained for U.S. government and agency debt obligations, debt obligations of government-sponsored enterprises ("**GSE**"), mortgage-backed securities ("**MBS**") issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac and amounts reported in AOCI regarding defined benefit pension plans.

- In other cases, provisions of the NPRs are unnecessarily punitive or are otherwise impractical and, as a result, should be modified. For example:

  - The Standardized Approach NPR's treatment of residential mortgage exposures should be revised, including to (i) eliminate the provisions that "taint" a first-lien residential mortgage loan because the same bank owns a second-lien residential mortgage loan on the same property that was not originated at the same time as the first-lien loan, because there is no reason why a qualifying first-lien residential mortgage exposure should be subjected to a higher risk weighting due solely to the fact that the bank makes a junior loan to the same borrower, (ii) permit inclusion in category 1 of non-"piggy-back" junior lien home equity lines of credit and closed-end mortgages, (iii) treat low-risk interest-only loans as category 1 loans because we believe that these loans typically have a lower loss experience than other residential mortgage loans that satisfy the criteria for category 1 with comparable loan-to-value ratios and are made with the banks' reliance upon the real estate collateral being less important because the loans are extended to borrowers with substantially greater resources, (iv) recognize the practical difficulties (and in some cases impossibility) of applying the proposed regime to outstanding residential mortgages, including to exposures that underlie securitizations, and therefore continue to apply the existing 50%/100% risk-weighting approach to those loans and apply the new risk-weighting regime prospectively to newly originated loans, and (v) treat all residential mortgages loans that meet the "qualified mortgage" criteria that will be established under the Truth in Lending Act ("**TILA**") as amended by Section 1412 of Dodd-Frank, as category 1 loans because it makes little sense for the government to carefully define lower risk mortgages in one context and then not to include such mortgages in a capital rule category that is also designed to capture lower risk mortgages.

  - o The underlying asset cap, which limits the notional amount of a bank's off-balance-sheet exposure to an asset-backed commercial-paper ("**ABCP**") program, should be extended to any off-balance-sheet securitization exposure – especially because commitments to customer-sponsored special purpose vehicles are generally being extended now by on-balance sheet ABCP conduits or directly by banks themselves.

- Some requirements of the NPRs are inconsistent with international standards without, in our view, any apparent justification and should be changed to conform with the Basel accords and/or the European Union's related rules. For example, the NPRs' definition of "financial institution," for purposes of the limitations on "significant" and "non-significant investments" in capital instruments of unconsolidated financial institutions is much broader than was contemplated by the BIS as part of Basel III and unnecessarily includes companies engaged in a wide range of financial activities, irrespective of whether those companies are subject to regulatory capital requirements, as well as, among others, all "covered funds" as defined for purposes of the Volcker Rule.[9] Accordingly, this definition should be modified to encompass only "regulated financial institutions" as defined in the Proposed Rules and institutions supervised by the Federal Reserve under Title I of Dodd-Frank. This revised definition would squarely address the underlying regulatory policy concerns with double-counting of capital by regulated entities in the system. In addition, perceived risks related to interconnectivity (with which the NPRs' expansive definition of financial institution may have been intended to deal) have been already separately addressed by other laws and regulations.[10]

- Still other provisions of the NPRs create unnecessary, confusing and burdensome duplication and should therefore be revisited by the Agencies. For example, under the regime contemplated by the NPRs, U.S. banks – particularly Advanced Approaches banks – will be subject to a proliferation of capital ratios, including the new supplementary leverage ratio, which will create market confusion as to inter-relationships among ratios and which ratio is the binding constraint for an

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[9] Dodd-Frank, § 619.

[10] In addition, although we believe that this may only be a scrivener's error, we believe it is crucial that the Advanced Approaches NPR's provision implementing Basel III's increased asset value correlation factor for exposures to financial institutions conform to Basel III and apply a 0.12 factor to parameter *e* instead of the 0.18 factor set forth in Section 131(e) of the Proposed Rules, because there is no apparent justification for this difference between the Advanced Approaches NPR and the Basel III rules.

individual bank. Stated bluntly, if the market cannot tell which out of a multiplicity of ratios is the "right" one, a natural tendency will be to treat them all as lacking credibility. This will also entail substantial duplication and expense. Thus, the Agencies should not apply the supplementary leverage ratio to any U.S. banks earlier than the January 1, 2018 date provided for in Basel III and, ultimately, a single leverage ratio applicable to all banks should be adopted, so that under no circumstances should Advanced Approaches banks (or any other banks for that matter) be required to comply with and report two leverage ratios.

- Conversely, in some instances, the NPRs fail to take into account the unique circumstances applicable to U.S. banks that do warrant careful and limited divergence from international standards and should therefore be revised accordingly. For example, the application of the Basel III NPR's minority interest limitations on Additional Tier 1 and Tier 2 capital instruments issued by depository institution subsidiaries of U.S. bank holding companies is inappropriate in the U.S. context given the unique holding company-depository institution subsidiary structure of most of the U.S. banking industry, would serve to significantly curtail an important source of cost-effective funding for U.S. banks and should be eliminated.

- Finally, in some cases, the rules set forth in the NPRs require clarifications and additional guidance from the Agencies. For example, in connection with certain aspects of the treatment of deferred tax assets ("**DTAs**") and how the DTA provisions of the Proposed Rules should be implemented in practice, the current administrative practice of measuring DTAs realizable through loss carrybacks by comparing the relevant DTAs to taxes paid in the relevant carryback period (and not by scheduling out the estimated future reversal of the relevant temporary differences) should be continued.

## II. Basel III NPR

### A. The Associations continue to believe that four of Basel III's adjustments to common equity Tier 1 should be modified in certain respects.

The Basel III NPR would apply to U.S. banks Basel III's elimination of the AOCI Filter in calculating common equity Tier 1 ("**CET1**"). Reflecting in regulatory capital increases or decreases in AOCI resulting from unrealized accounting "gains" or "losses" weakens the effectiveness of regulatory capital ratios as a realistic, appropriate and credible measure of financial strength, effectively either understating or overstating the ratios. Recognition of (i) unrealized losses that are unlikely to be realized on highly liquid debt securities with no credit risk would effectively impose a capital charge on banks based on nothing other than interest rate movements that likely are not reflective of the entity's net interest rate exposures and (ii) unrealized gains that similarly are unlikely to be realized provides a capital benefit to banks that may be illusory. The Basel III NPR would also apply to U.S. banks the deductions from CET1 of mortgage servicing assets ("**MSAs**"), DTAs and certain significant and non-significant investments in the capital of "financial institutions", subject to certain thresholds.

We continue to believe that the treatment of each of these adjustments should be modified in certain respects, at least for U.S. banks and perhaps internationally. We discuss each below. Although we strongly support international consensus, sound capital policies for U.S. banks should not be sacrificed in the interest of that consensus.

1. AOCI[11]

Although the Agencies have included AOCI (therefore removing the AOCI Filter) within CET1 as a definitional matter (in Section 20(b)(4) of the Proposed Rules), the Agencies have asked for comment (in Question 16) concerning the pros and cons of permitting banks to exclude from regulatory capital (that is, retain the AOCI Filter for) "unrealized gains and losses on debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate (for example, U.S. government and agency debt obligations and U.S. GSE debt obligations)." We strongly support permitting banks to exclude unrealized gains and losses on those securities from regulatory capital.

We continue to believe that removal of the AOCI Filter is ill-advised and will detract from the credibility of capital requirements.[12] Removal of the AOCI Filter would:

- force the recognition in capital ratios of unrealized gains and losses that are temporary in nature and result principally from movements in interest rates as opposed to changes in credit risk, that are unlikely ever to be realized and that

[11] This Part II.A.1 is responsive to Questions 16 and 17 of the Basel III NPR.

[12] We have addressed this issue at length in prior letters to the Agencies. *See, e.g.*, the letter, dated October 27, 2011, from The Clearing House to each of the Agencies and the letter, dated March 1, 2012, submitted jointly by The Clearing House and the American Bankers Association and addressed to Arthur W. Lindo of the Federal Reserve, both dealing exclusively with the AOCI Filter (together, the "**Prior AOCI Letters**"). *See also* the letter, dated November 5, 2010, from The Clearing House to the Agencies, the Federal Reserve Bank of New York and the Office of Thrift Supervision, and the letter, dated April 16, 2010, from The Clearing House to the BIS, each addressing, among other issues, the removal of the AOCI Filter.

typically result in no effect on the bank and, therefore, depart from a true risk-based system by raising or lowering regulatory capital regardless of any change in real risk;

- inevitably force banks to shorten the maturities of debt instruments in their securities portfolios, including U.S. Treasury securities, and limit their investments in longer duration assets, including 30-year Fannie Mae and Freddie Mac MBS and debentures, in order to reduce the impact on regulatory capital of unrealized gains and losses (both positive and negative) resulting from changes in interest rates, and thereby distort the markets for these securities and raise long-term borrowing costs for the U.S. Government and the GSEs;

- force banks to maintain ratios of both CET1 to risk-weighted assets and Tier 1 capital to risk-weighted assets substantially above the levels that would otherwise apply after buffers in order to avoid the sanctions applicable to banks that fall into the buffer range;

- introduce substantial volatility into reported CET1 and Tier 1 capital as measures of capital (although it does not exist as a substantive economic matter); and

- force banks to hold securities as held to maturity instead of available-for-sale where possible, limiting the usefulness of these securities for liquidity risk management purposes.

Crucially, the aggregate and negative synergistic effects of the foregoing consequences of the removal of the AOCI Filter will deprive banks of an important risk management tool. Many banks currently hold high-quality fixed-rate securities (largely U.S. Treasury securities and debt obligations of U.S. agencies and GSEs[13]) in their available-for-sale portfolios to hedge interest rate risk arising out of fixed-rate liabilities (including deposits). Because of the interest rate hedge role of these securities, the likelihood that the bank would sell the securities and remove the hedge is particularly remote. If the AOCI Filter is removed for these securities, then, contrary to sound prudential and risk management practices, banks would effectively be

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[13] We, as we assume the Agencies were in Question 16, are using the terms "U.S. government agency" and "GSE" consistent with the meanings used in the existing capital rules (*e.g.*, footnotes 38 and 43, respectively in the Federal Reserve's general risk capital guidelines applicable to bank holding companies, 12 C.F.R. Part 225, Appendix A). We realize that the U.S. government's support of Fannie Mae and Freddie Mac under current arrangements applicable to their conservatorships may change and, accordingly, although it is currently appropriate to treat Fannie Mae and Freddie Mac as GSEs for purposes of continued application of the AOCI Filter, the Agencies may re-visit that decision if the status of Fannie Mae and Freddie Mac changes.

forced to reduce these portfolios and/or decrease their duration. This would in turn result in less effective hedging, as well as the development of alternative hedging strategies in an attempt to compensate for such decreased effectiveness. Those strategies are likely to involve interest rate swaps, collars and floors that are more costly to implement and may be less predictable as a hedging strategy. Moreover, the proposed single counterparty credit limit rules currently under consideration by the Agencies as part of the implementation of Section 165 of Dodd-Frank may very well have the effect of reducing the ability of banks to actually implement such alternative hedging strategies. Thus, the removal of the AOCI Filter in general and, in particular, with respect to U.S. Treasury securities, debt obligations of U.S. agencies and GSEs, as well as MBS issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac, will have real negative consequences for banks' ability to effectively hedge their interest rate risk exposures and will only serve to increase systemic risks – clearly effects that run squarely counter to sound public policy objectives, including as expressed by Dodd-Frank.

In addition, the potential impact on banks of removing the AOCI Filter is made more severe by new liquidity regulations, including the liquidity coverage ratio in the Basel III Liquidity Framework and the short-term liquidity requirements in the Federal Reserve's proposed rules under Dodd-Frank Section 165, both of which define the "stock of liquid assets" or "highly liquid assets" in a narrow fashion that will force banks to rely on U.S. Treasury securities and debt obligations of U.S. agencies and GSEs in order to achieve compliance.

We understand that both the Financial Accounting Standards Board ("**FASB**") and the International Accounting Standards Board ("**IASB**" and, together with FASB, the "**Boards**") continue to evaluate the accounting treatment of securities portfolios under U.S. GAAP and international financial reporting standards ("**IFRS**"), respectively (as discussed in the Prior AOCI Letters) and that, pending finalization of those deliberations and possible further consideration by both the Agencies and international regulators growing out of those deliberations, the Agencies are reluctant to retain the AOCI Filter in its entirety. Taking into account those considerations, we believe that the proper test for establishing a category of instruments for which the AOCI Filter should be retained is securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate as opposed to credit risk, as contemplated by Question 16. Accordingly, we strongly urge the Agencies to retain the AOCI Filter for unrealized gains and losses on those securities that clearly qualify under such a standard: U.S. government and agency debt obligations and debt obligations of GSEs, as well as MBS issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac. These securities represent a meaningful component of securities in banks' available-for-sale securities portfolios and, as interest rates fluctuate, generate unrealized accounting gains and losses that are reflected in AOCI. Retention of the AOCI Filter for these securities would substantially alleviate our members' concerns with the AOCI Filter's removal.

Our reasoning is straightforward, and we believe compelling, as to why the AOCI Filter should be retained for securities whose changes in fair value are attributable to benchmark interest rates and that do not have credit risk. These are precisely the securities that banks will hold in substantial amounts in order to comply with internal and new regulatory liquidity requirements, as noted above, making it very unlikely that banks will transfer these securities and realize gains and losses as accounting values change with interest rates. Given the nature of the securities, no evaluation of credit risk is relevant to the decision-making. As noted in the Prior AOCI Letters, the component of capital that is impacted by the removal of the AOCI Filter is CET1. CET1 is "going concern", not "gone concern", capital. For a going concern, the unrealized gains and losses on U.S. Treasury, U.S. government agency and GSE securities, as well as particular MBS securities, even if eventually realized, are highly unlikely to be realized in the amounts recorded on any given day of revaluation. If a bank has a need for additional funding, its first approach customarily would not be to sell these types of securities, thereby realizing the gain or loss, but instead would be to use the securities as collateral to obtain secured financing. Additionally, when banks need to sell portions of their investment portfolios in order to accommodate changes in funding, they have an opportunity to make a variety of decisions that affect the amount of gains or losses recognized, including which assets to sell, the timing of sales and structuring decisions with respect to particular sale transactions that impact the amount of gain or loss.

It is beyond question that, notwithstanding the on-going political debates surrounding the United States' debt limit, U.S. Treasury securities are the benchmark securities for fixed income markets because they are perceived to have no comparative credit risk. Yields on debt obligations of U.S. government agencies are highly correlated to yields on U.S. Treasury securities with comparable maturities.[14] Similarly, yields on GSE debt securities are highly correlated with yields on U.S. Treasury securities and trade at consistent and very narrow spreads to U.S. Treasury securities having comparable maturities. Attached as **Annex 2** hereto are graphical results of analyses that demonstrate the high degree of correlation (*i.e.*, $R^2$ of .951, .976, .968 and .979, respectively) between the yields of U.S. Treasury securities with maturities of 30 years and 10 years and Fannie Mae and Freddie Mac debt securities with 30-year coupons.[15]

[14] To the extent there are differences in the trading prices between U.S. Treasury securities and obligations of other U.S. agencies of comparable maturities, such differences are largely due to the significantly larger and more liquid market for U.S. Treasury securities.

[15] These correlations are measured over the periods December 6, 1984 to December 6, 2011 and February 11, 2000 to February 11, 2012, respectively.

With respect to our proposed retention of the AOCI Filter for MBS issued or guaranteed by Ginnie Mae, Fannie Mae or Freddie Mac, those MBS entail no credit risk *vis-à-vis* the underlying obligor or real property because of the agency guarantees but, instead, have trading prices that depend primarily upon their relative value *vis-à-vis* other agency securities and upon movements in interest rates. However, the interest rate analysis is more complex because interest rate movements also affect prepayment speeds for underlying loans and, accordingly, the duration of the MBS. Attached as **Annex 3** hereto are graphical results of analyses that also demonstrate the high degree of correlation (*i.e.*, $R^2$ of .979, .976 and .981, respectively) between yields on 30-year GSE and Ginnie Mae MBS and 10 year U.S. Treasury securities.[16] As such, we believe that the AOCI filter should be retained for agency and GSE MBS as well.[17]

We recognize, of course, that all bond yields, including those for corporate bonds, will bear some correlation to yields on U.S. Treasury securities. Attached as **Annex 4** hereto are graphical results of analyses of the correlation of various composite corporate bond yields versus U.S. Treasury securities.[18] These correlations are significantly lower (*i.e.*, $R^2$ of .64, .574 and .356, respectively) than those illustrated in either **Annex 2** or **Annex 3** between GSE debt obligations and GSE and Ginnie Mae MBS, on the one hand, and U.S. Treasury securities, on the other hand. We believe this provides further support for the proposition that agency and GSE debt securities and MBS are perceived to have little comparable credit risk and that changes in their fair value are predominantly attributable to interest rate fluctuations.

In order to assist the Agencies' consideration of the impact of retaining the AOCI Filter for U.S. Treasury, U.S. government agency and GSE debt obligations and Ginnie Mae, Fannie Mae and Freddie Mac MBS, 14 member banks of The Clearing House calculated the impact on their ratios of Tier 1 common to risk-weighted assets if the AOCI Filter had been removed as of June 30, 2012 and, on that date, there was a 100, 200 or 300 basis point parallel upward shift in the yield curve.

Not surprisingly in light of the current historically low interest rate environment (and banks therefore holding a stock of previously purchased securities with higher interest rates), the removal of the AOCI Filter as of June 30, 2012 would initially result in an increase in banks' capital levels relative to current rules. The average increase in Tier 1 common ratios across the 14 banks (calculated as a simple average and not on a weighted-average basis based upon total assets or some other measure) resulting from the initial removal of the AOCI Filter would be 36

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[16] These correlations are measured over the periods December 6, 1984 to May 6, 2012.

[17] *See also supra* note 12.

[18] These correlations are measured over the periods September 23, 2002 to March 23, 2012,

basis points (ranging from 20 to 83 basis points).[19] For the 14 member banks, this would translate into an aggregate increase of $17.5 billion of Tier 1 common.

If interest rates then increased, a decrease in Tier 1 common ratio would occur. The average gross impact across the 14 member banks (calculated as a simple average and not on a weighted-average basis based upon total assets or some other measure) would be a decrease of 32 basis points, 74 basis points and 120 basis points for a 100, 200 or 300 basis point parallel upward shift in the yield curve, respectively (ranging from 8 basis points to 61 basis points for a 100 basis point increase in the yield curve, from 23 basis points to 135 basis points for a 200 basis point increase in the yield curve and from 46 to 214 basis points for a 300 basis point increase in the yield curve). For the 14 member banks discussed above this 100, 200 and 300 basis point upward shift in the yield curve would translate into an aggregate gross decrease of $16.1, $37.7 and $62.1 billion in Tier 1 common, respectively.

When combining the increase in Tier 1 common resulting from the initial removal of the AOCI Filter and the decrease in capital from a subsequent parallel shift in the yield curve, the net aggregate impact for the 14 member banks of The Clearing House relative to the current general risk based capital rules would be a net (i) increase of $1.4 billion, (ii) decrease of $20.1 billion and (iii) decrease of $44.6 billion of Tier 1 common for the 100 basis point, 200 basis point and 300 basis point shift in the yield curve, respectively.

The data for the 14 member banks clearly show substantial volatility in their ratios of Tier 1 common to risk-weighted assets based upon these standard "shock" measures for interest rate risk, implying an effective need for substantial cushions above minimum requirements after buffers.

In light of the artificial volatility in capital calculations evidenced above, the consequence of reflecting in regulatory capital increases or decreases in AOCI resulting from unrealized accounting "gains" or "losses" weakens the effectiveness of regulatory capital ratios as a realistic and appropriate measure of financial strength, effectively either understating or overstating the ratios. This is a concern not only for banks and the Agencies as their regulators, but also for analysts and investors that consider regulatory capital ratios. More specifically, requiring recognition of:

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[19] The data presented herein assumes a 35% effective tax rate and does not take into account other effects of the removal of the AOCI Filter such as additional impacts to capital from DTA disallowances as described in the March 1, 2012 Prior AOCI Letter.

- unrealized losses that are unlikely to be realized on highly liquid debt securities with no credit risk would effectively impose a capital charge on banks based on nothing other than interest rate movements that likely are not reflective of the entity's net interest rate exposure;

- unrealized gains that similarly are unlikely to be realized provides a capital benefit to banks that may be illusory;[20] and

- unrealized gains and losses that result from interest rate changes on high-quality available-for-sale securities held to hedge the interest rate risk of fixed-rate liabilities—but not the changes in value of the fixed-rate liabilities themselves—provides an inaccurate and incomplete view of the actual economic effect of interest rate changes on a bank's balance sheet.

Retaining the AOCI Filter for U.S. Treasury, U.S. government agency and GSE debt securities and Ginnie Mae, Fannie Mae and Freddie Mac MBS will help alleviate this distortion of capital ratios.

In addition, we urge the Agencies to preserve the AOCI Filter with respect to amounts reported in AOCI regarding defined benefit pension plans. Although there are several variables that impact this defined benefit plan component of AOCI, the predominant factor is the discount rate. The discount rate may fluctuate year to year based on short-term movements in interest rates, but the underlying liability is typically of a long duration (*e.g.*, 15 to 20 years or longer) and therefore these temporary fluctuations are not likely to be realized. Data provided by nine of the member banks of The Clearing House indicates that the amount recorded in AOCI with respect to defined benefit pension plans is approximately six times more sensitive to changes in the discount rate than any other factor (*e.g.*, differences in actual vs. assumed rates of asset returns and changes in salary scale). For these nine banks, the average Tier 1 common ratio impact of defined benefit related pension AOCI is 55 basis points as of June 30, 2012 (with a range of 15 basis points to 134 basis points). Further, U.S. GAAP requires that a portion of the projected benefit obligation, which includes anticipated future but not yet incurred compensation increases, be reported in AOCI, notwithstanding that such amounts do not reflect the true economics or obligations relating to the pension plan.

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[20] This is a very real scenario for securities purchased by banks in the pre-crisis higher interest rate environment. As indicated above, the aggregate capital benefit for the 14 member banks of The Clearing House would be an increase of $17.5 billion of Tier 1 common from the initial removal of the AOCI Filter.

In the event that the Agencies decide not to retain the filter for AOCI pertaining to defined benefit plan obligations, we recommend that the accumulated benefit obligation, which does not include anticipated future compensation increases, be used for regulatory capital purposes instead of the projected benefit obligation.

For the reasons stated above, we believe that the AOCI Filter regarding defined benefit pension plans should be preserved regardless of the Agencies' decision relating to the available-for-sale securities described above (*i.e.*, U.S. Treasury, U.S. government agency and GSE debt securities (and MBS in the case of Ginnie Mae, Fannie Mae and Freddie Mac)). In addition, because the impact on CET1 from amounts reported in AOCI for these available-for-sale securities and defined pension plan obligations are inversely related to a change in interest rates, the AOCI Filter should be retained for defined pension plan obligations if the AOCI Filter for these available-for-sale securities is retained because otherwise the impact on capital from a change in interest rates will be incomplete.

2. MSAs[21]

Section 22(d)(3) of the Proposed Rules provides that, if the total amount of MSAs that a bank deducts from CET1 as a result of Basel III's 10%/15% limitation[22] is less than 10% of the fair value of the MSAs, then the bank must deduct an additional amount of MSAs equal to the difference between 10% of the fair value of MSAs and the amount otherwise deducted pursuant to the 10%/15% limitation. The Agencies do not suggest any financial or economic rationale for the provision, but comment in the preamble to the Basel III NPR that this additional deduction is required by Section 475 of the Federal Deposit Insurance Corporation Improvement Act of 1991, as amended[23] ("**FDICIA**"). We do not believe that FDICIA § 475 in its current form necessarily requires this additional deduction. Imposition of the additional deduction, particularly when not necessarily required, would unfairly and needlessly penalize U.S. banks.

FDICIA § 475 permits the Agencies to determine the amount of MSAs that depository institutions may include in calculating capital "if – (1) such servicing rights are valued at no more than 90 percent (or such other percentage exceeding 90 percent but not exceeding 100

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[21] This Part II.A.2 is responsive to Question 35 in the Basel III NPR.

[22] By the "**10%/15% limitation**," we mean the provision in Basel III and the Proposed Rules requiring banks to deduct from CET1 MSAs, DTAs and significant investments in common stock of unconsolidated financial institutions that individually exceed 10% of CET1 or, in the aggregate, exceed 15% of CET1.

[23] 12 U.S.C. § 1828 note.

percent . . ." of their fair market value. Congress later amended FDICIA § 475 to add a paragraph (b) reading as follows:

> "The appropriate Federal banking agencies may allow readily marketable purchased mortgage servicing rights to be valued at more than 90 percent of their fair market value but at not more than 100 percent of such value, if such agencies jointly make a finding that such valuation would not have an adverse effect on the deposit insurance funds or the safety and soundness of insured depository institutions."

First, we note that FDICIA § 475's fair value test only applies to purchased MSAs and not retained MSAs. The adjustment in Section 22(d)(3) purports to apply to both purchased and retained MSAs. Were it to be retained, it should only apply to purchased MSAs as referred to by FDICIA § 475, which, again, appears to be the sole basis for this additional deduction.

Second and more fundamentally, Section 475(b) provides clear authority for the Agencies to remove the 90% of fair market value limitation, subject to the determination by the Agencies that its removal would not have an adverse effect on the deposit insurance fund[24] or the safety and soundness of insured depository institutions.

It should be incontrovertible that the "not . . . adverse" standard in Section 475(b) would be satisfied if amendments to regulatory capital rules require more capital to be retained against MSAs notwithstanding removal of the 90% of fair value test than is required under existing rules. Simple arithmetic proves that is the case as a result of the special minimum risk weight (250%) applied to all MSAs. Under existing rules (and based on the minimum original ratio of 8% total capital to risk-weighted assets), for each $1,000 of MSAs, a bank is required to maintain $172 of capital (calculated as the sum of (i) $100 because of the required write-off of 10% of the fair value of the MSAs and (ii) $72 of additional capital calculated as $900 x 100% risk weight x 8%). Under the Proposed Rules, MSAs exceeding the 10%/15% limitation are deducted dollar-for-dollar from capital, and any MSAs that are not so deducted are risk-weighted 250%. Even if one assumes that (i) a bank has a limited amount of MSAs such that it is not required to deduct any MSAs from CET1 by virtue of the 10%/15% limitation and (ii) the bank will manage its capital ratios to the minimum requirement of total capital to risk-weighted assets of at least 8% (*i.e.*, without regard to capital buffers or a margin above buffers that a

[24] FDICIA § 475 refers to deposit insurance funds because, at the time of FDICIA enactment the Federal Deposit Insurance Act provided for two deposit insurance funds – one for banks and another for savings associations. FDICIA now provides for a single deposit insurance fund.

bank may perceive as necessary), the bank would be required to maintain $200 of capital against each $1,000 of MSAs (calculated as $1,000 x 250% risk weight x 8%) – *that is, 16% more capital against the same MSAs than is required under existing rules*. The real increase in capital as a result of Basel III will, of course, be much more substantial. For example, if one assumes that a bank has a limited amount of MSAs and, accordingly, is not required to deduct MSAs from CET1 because of the 10%/15% limitation but maintains a ratio of total capital to risk-weighted assets of 10.5% (which itself is unrealistically low because it allows for no volatility in capital to avoid dipping into the Capital Conservation Buffer and triggering its sanctions), the amount of capital maintained against each $1,000 of MSAs would be $262.50 (calculated as 250% x $1,000 x 10.5%).

Thus, we believe that FDICIA § 475 does not require the Agencies to continue Section 475(a)'s fair value limitation and the Agencies can and should make the "not . . . adverse" determination permitted by Section 475(b). We urge them to do so and, accordingly, to eliminate Section 22(d)(3) of the Proposed Rules.

3. DTAs[25]

The provisions dealing with DTAs in the Basel III NPR are principally set forth in Sections 22(a) and (d), and 300(c). Further guidance is contained in the preamble to the Basel III NPR. We commend the Agencies on the issuance of the DTA-related provisions of the Proposed Rules and believe the proposals go a long way towards clarifying the treatment of DTAs for U.S. banks under Basel III as proposed to be implemented for U.S. bank regulatory capital purposes. As described in further detail below, there are several areas, however, in which we believe guidance should be added or the existing guidance clarified by the Agencies.

a. *Banks should be permitted to continue the administrative practice of measuring DTAs that could be realized through loss carrybacks by comparing the relevant DTAs to the taxes paid in the relevant carryback period (and not by scheduling out the estimated future reversal of the relevant temporary differences).*

The Basel III NPR provides that a bank is not required to deduct from its CET1 "net DTAs arising from timing differences that the [BANK] could realize through net operating loss carrybacks."[26] The Basel III NPR goes on to provide that a bank filing tax returns as a member of a consolidated group should not credit an amount of these DTAs in excess of the amount that

[25] This Part II.A.3 is responsive to Question 35 in the Basel III NPR.

[26] Proposed Rules, § 22(d), note 14.

the bank "could reasonably expect to have refunded by its parent" corporation.[27] However, because the Basel III NPR does not describe how this carryback provision is to be applied in practice, we request that the Agencies confirm that the administrative practice followed by existing U.S. regulatory provisions in this area[28] (the "**Current Rules**") of comparing relevant DTAs arising from temporary differences to the taxes paid in the relevant carryback period (and not by scheduling out the estimated future reversal of the relevant temporary differences) will continue to apply.

The Current Rules were originally adopted as a simplifying convention to reduce complexity. Before finalizing the Current Rules, the Federal Reserve asked for comments on whether "all temporary differences should fully reverse at the report date" in determining the carryback potential of DTAs. All of the comments it received to its notice of proposed rulemaking recommended that this proposed rule be adopted because, as one commenter noted, the rule eliminated the "burden of scheduling the 'turnaround' of temporary differences."[29] Accordingly, the Federal Reserve adopted this reporting convention, noting that its adoption was appropriate because "these amounts will generally be realized."[30] The Current Rules also enhance comparability across the population of banks by removing subjective judgments from the calculations.

The general goals of minimizing complexity and enhancing comparability continue to be guiding principles in the Proposed Rules.[31] Because the foregoing reasons for calculating the carryback measurement on the basis that a bank's carryback capacity is available to all of its DTAs in the same jurisdiction continue to exist, we recommend that the Basel III NPR be clarified to confirm expressly that banks may continue to apply the current administrative practice in this context (*i.e.*, of comparing relevant DTAs arising from temporary differences to the taxes paid in the relevant carryback period).

Additionally, in determining the DTA that could be realized by net operating loss carrybacks, the provision in Section 22(e)(3) regarding netting of deferred tax liabilities

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[27] *Id.*

[28] *See* 12 C.F.R., Part 225, § II.B.4 of Appendix A (Federal Reserve rules applicable to bank holding companies); 12 C.F.R., Part 208, § II.B.4 of Appendix A (Federal Reserve rules applicable to state member banks); 12 C.F.R. § 325.5(g), 12 C.F.R., Part 325, § I.B.5 of Appendix A (FDIC rules applicable to state non-member banks); and 12 C.F.R., Part 3, §§ 2(c)(1), 2(c)(3) and 2(c)(6) of Appendix A (OCC rules applicable to national banks).

[29] 59 Fed. Reg. 65,920, 65,922 (Dec. 22, 1994).

[30] 59 Fed. Reg. 65,920, 65,922, 65,923.

[31] Basel III NPR, at 52,796, 52,800.

("**DTLs**") against DTAs states that the DTLs are allocated between and in proportion to: (i) "DTAs that arise from operating loss and credit carryforwards (net of any related valuation allowances, but before any offsetting of DTLs)" and (ii) "DTAs arising from temporary differences *that the Bank could not realize through net operating loss carrybacks* (net of any related valuation allowances, but before any offsetting DTLs)."[32] It appears clear, therefore, that DTAs which could be realized by net operating loss carrybacks are determined first, before any DTLs are allocated against the remaining DTAs after taking such carryback into account. There is, however, a potential ambiguity created by the language in footnote 14 of the Basel III NPR, which states that "[a] bank is not required to deduct from its CET1 *net* DTAs arising from timing differences that the bank could realize through net operating loss carrybacks."[33] We believe the use of the word "net" here was intended to refer to "net of valuation allowances" as opposed to "net of allocated DTLs" because the incorporation of the latter term would negate the language in the rule itself as set forth above.

The following example illustrates in our view the proper application of the rule per the text of the Basel III NPR. As of the reporting date, we assume the following facts:

- Bank has tax capacity for carryback of $700. Bank has Gross DTA–Temporary Differences ("**Gross DTA-Temps**") of $800 and Gross DTA-Foreign Tax Credits ("**Gross DTA-FTCs**") of $400 for total Gross DTAs of $1,200. Bank has DTLs of $300.

Accordingly, Bank should first reduce DTA-Temps by its $700 tax carryback capacity, which leaves $100 of Gross DTA–Temps "that could not be realized by NOL carryback" as well as the Gross DTA-FTCs of $400 (total of $500 Gross DTAs). Bank should then allocate $60 ($100/$500, or 20% X $300) of the DTLs against the Gross DTA-Temps, and $240 ($400/$500, or 80% X $300) of the DTLs against the Gross DTA-FTCs. The result is a Net DTA-Temps of $40 and Net DTA-FTCs of $160.

If, contrary to what we believe the proper reading of "net" in footnote 14 to be, it is intended by the Federal Reserve to require allocating DTLs solely against Gross DTA Temps *before* analyzing tax carryback capacity, then the following would occur under the example above. Bank would net the entire $300 DTL first against the Gross DTA –Temps of $800 before applying its tax carryback capacity. This would leave $500 Gross DTA-Temps to be absorbed by the $700 carryback capacity and the entire $500 Gross DTA-Temp would be "realized by

[32] Proposed Rules, § 22(e)(3) (emphasis added).

[33] Proposed Rules, § 22(d) n. 14 (emphasis added).

carryback." Only the remaining $400 Gross DTA-FTC would remain with no DTL to be allocated against it. This would effectively eviscerate the clear intent of the Basel III NPR that DTLs should be allocated between DTA-Temps and DTAs that arise from operating loss and tax credit carryforwards.[34] We believe the use of the word "net" in footnote 14 was not intended to have this effect.

b. *Banks should treat DTAs in the same fashion that they treat DTLs in making capital deductions and adjustments under the Basel III NPR.*

The Basel III NPR provides that a DTL can be netted against an asset that is subject to capital adjustment or deduction under the Basel III NPR provisions if it is associated with the asset and if the DTL would be extinguished if the associated asset were written off.[35] We recommend that banks similarly should be permitted to net a DTA against a mark-to-market or similar adjustment with respect to an asset (*e.g.*, in the case of a cash flow hedge or an available-for-sale security) or a liability (*e.g.*, in the case of a bank's own debt) if it is associated with the adjusted value of the asset or liability that itself is subject to capital adjustment or deduction under the Basel III NPR and the DTA would be de-recognized if the adjustment in value were reversed.

The Basel III NPR notes that the principles provided for DTLs are "generally consistent with the approach that the agencies currently take with respect to the netting of DTLs against goodwill."[36] The Current Rules generally provide that DTLs associated with goodwill may either be netted against the goodwill or against DTAs as part of the calculation of the maximum allowable amount of DTAs for regulatory capital at the bank's option for the reporting period. However, the DTL cannot be netted against both.[37] The same rule applies for MSAs under the Current Rules.[38]

We believe that the guiding principle to be derived from the treatment of DTAs and DTLs described above is that banks should be permitted to associate the deferred tax effects

[34] Proposed Rules, § 22(e)(3); Basel III NPR, at page 52,823.

[35] *See* Proposed Rules, § 22(e)(1). The preamble notes that "banking organizations would be prohibited from using the same DTL for netting purposes more than once." Basel III NPR, at page 52,823.

[36] Basel III NPR, at 52,823.

[37] *See* Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies, Reporting Form FR Y-9C, Line Item Instructions for Regulatory Capital, Schedule HC-R, pages HC-R-8-10.

[38] *See Id.*

(both DTLs and DTAs) with the assets or liabilities (or marks thereon) being adjusted under the Basel III NPR to which they relate. This appears to have been the intent of the Basel III NPR. For example, the Basel III NPR states that banks must deduct any unrealized gain and add any unrealized loss on cash flow hedges to capital, "net of applicable tax effects." The Basel III NPR here does not limit the tax effects to DTLs alone.[39] While we note that the deferred tax effects of the items which are adjusted for regulatory capital purposes may be DTAs or DTLs, the language in Section 22(e) only refers to DTLs.[40] We respectfully submit that this limitation appears to be unintended, because it is inconsistent with the Current Rules and other parts of the Basel III NPR as described above. Accordingly, we recommend that the language of Section 22(e) be clarified so that it also applies to DTAs where relevant.[41] Moreover, assuming DTAs are given equivalent treatment with DTLs, banks should be able to elect their proper treatment in accordance with our recommendation in Part II.A.3.c immediately below.

c. *Banks should be able to elect to net or not to net deferred taxes with the associated assets and liabilities that are subject to capital deduction or adjustment under the Basel III NPR and that election should be made separately on a given reporting date for each different item (including, during the transition period, items reported in AOCI).*[42]

The Basel III NPR provides that items being deducted from regulatory capital or subject to the 10%/15% limitation are made net of any associated DTL, "in accordance with Section 22(e)."[43] However, this cross-reference to Section 22(e) creates an ambiguity because, as discussed above, Section 22(e) sets forth the conditions under which such netting is characterized as "permitted" rather than "required" or "mandated." In light of the principle set forth in the Basel III NPR noting[44] the current treatment of goodwill as a guide (*i.e.*, under the Current Rules, a bank can choose to net DTLs associated with goodwill against the goodwill or

[39] Proposed Rules, § 22(b)(1); Basel III NPR, at 52,819.

[40] Proposed Rules, § 22(e)(1) provides in relevant part that the "netting of DTLs against assets that are subject to deduction . . . is permitted. . . ." Proposed Rules, § 22(e)(1).

[41] *See* Part II.A.3.b, *supra*, on the election to treat deferred taxes either as part of the associated assets or liabilities or separately as part of the testing of DTAs under the Basel III NPR.

[42] This Part II.A.3.c is responsive to Question 36 of the Basel III NPR.

[43] *See, e.g.*, Proposed Rules, §§ 22(a)(1), 22(a)(2), 22(a)(5), 22(d)(1)(ii) and 22(d)(1)(iii).

[44] *See* Basel III NPR at 52, 823.

to treat them as part of its analysis of DTAs[45]), the word "permitted" suggests a choice to net the DTL directly against the MSAs or against DTAs on a pro-rata basis. We recommend that this approach of allowing banks a choice on the treatment of their deferred taxes be confirmed in the final regulations and be applied to both DTAs and DTLs.

We also recommend that a bank should be able to change its method of treating deferred tax items on each reporting date as changes in facts and circumstances warrant. Previously, The Clearing House presented examples of why a periodic election of this nature should be adopted.[46] These examples demonstrate why a bank may make a principled decision to net DTLs against MSAs or, alternatively, to net them against DTAs. Because the change in a bank's tax attributes can create a new tax profile under which a bank reasonably would desire to treat its deferred tax items differently than in a prior reporting period for regulatory capital purposes, this election should be available to banks on each reporting date.[47]

The proposals for treating AOCI items during the transition period raise particular issues with respect to the treatment of deferred taxes.[48] In general, unlike under the Current Rules, the impact of items reported in AOCI is to be included in regulatory capital under the Basel III NPR.[49] When fully effective, the adjustment for such items under the Current Rules would not be permitted under the Basel III NPR. Under the Current Rules, the deferred taxes associated with the marks on available-for-sale debt securities can be recorded net in the adjustment

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[45] 59 Fed. Reg. 65,923 (Federal Reserve's discussion on the gross-up of intangibles under DTA rules adopted in December 1994); Instructions for Preparation of Consolidated Financial Statements for Bank Holding Companies, Reporting Form FR Y-9C, Line Item Instructions for Regulatory Capital, Schedule HC-R, page HC-R-9, Item (c2). *See also* Part II.A.3.b *supra*.

[46] The Clearing House previously submitted letters to the Agencies on the Basel III proposals dealing with DTAs, the first of which was dated September 19, 2011 and the second of which was dated December 13, 2011 (collectively, the "**Prior DTA Letters**"). *See* pages 8-9 of the Prior DTA Letter dated September 19, 2011 and pages 2-3 of the Prior DTA Letter dated December 13, 2011.

[47] In the example set forth in the Prior DTA letter dated December 13, 2011, in Year 1, the bank logically would choose to net DTLs against an NOL DTA that would otherwise be disallowed. However, because of a change in circumstances in Year 2 whereby the bank was able to utilize its NOL, the bank would logically prefer to net its DTLs against its MSAs in that year so that none of them would fail the 10%/15% limitation test.

[48] The recommendations on the treatment of AOCI items for tax purposes discussed herein is subject to the recommendations made elsewhere on the treatment of certain items reported in AOCI. *See* Part III.A.1, *supra*.

[49] *See* Proposed Rules, § 22(b)(1), 300(c)(3); Basel III NPR, at 52819, 52827-52828; *supra* note 35. Under current U.S. GAAP, in general, the following items are reported in AOCI - unrealized gains and losses on available-for-sale securities (AFC Subtopic 320-10), gains and losses relating to defined benefit pension obligations (ASC Subtopics 715-30, 715-60, 715-20 and 958-715) and gains and losses on cash flow hedges on items that are reported on a bank's balance sheet at fair value (ASC Topic 815).

made to regulatory capital, or a bank can elect to identify them separately and treat them as an overall part of its capital calculations relating to DTAs and DTLs.[50]

The Basel III NPR has separate transition rules for items reported in AOCI. In 2013, all of the adjustments relating to AOCI can be continued as under the Current Rules. Beginning in 2014, the amount of the adjustments under the Current Rules starts to decrease in 20% annual increments. Thus, in 2014, the adjustment under the Current Rules decreases by 20% to 80%; in 2015, it is reduced by 40% to 60%, etc.[51] The Basel III NPR does not discuss the treatment of deferred taxes associated with items in AOCI either with respect to the transition period or when the Proposed Rules are finalized. Additional guidance on the treatment of deferred taxes in both cases would be helpful.

The simpler case will be when the Proposed Rules are finalized. In this instance, the AOCI items would generally be included in regulatory capital.[52] The deferred taxes relating to the components of AOCI, which are included on a bank's balance sheet, would then simply become a part of the 10%/15% limitation calculations relating to deferred taxes arising from temporary differences.

The treatment of deferred taxes on AOCI items during the transition period is more complicated. The Current Rules' provision allowing banks to elect to exclude or include from the DTA limitation calculation the associated deferred tax effects of AOCI adjustments was adopted to avoid creating "significant complexity" in making adjustments to regulatory capital.[53] For this reason, we recommend that banks be permitted to make a similar election during the transition period. Accordingly, for banks choosing to treat AOCI items without regard to associated deferred taxes, the full amount of deferred taxes associated with AOCI items would be included in the deferred taxes relating to temporary differences subject to the 10%/15% limitation calculations and be subject to the relevant transitional rules for such items.[54] The related AOCI items would then be adjusted for regulatory capital purposes on a gross basis under the AOCI transition rules. For banks choosing to treat AOCI items net of deferred taxes, only a percentage of the deferred taxes associated with these items would be

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[50] *Id.*

[51] *See* Proposed Rules, § 300(c)(3); Basel III NPR, at 52,827-52,828.

[52] *See supra* note 47.

[53] For the Federal Reserve and FDIC analyses of this point, *see* 59 Fed. Reg. 65,920 (Dec. 22, 1994) at 65,924, and 60 Fed. Reg. 8,182 (Feb. 13, 1995) at 8,186, respectively. For the discussion by the OCC of this same issue, *see* 60 Fed. Reg. 7,903 (Feb. 10, 1995) at 7,907.

[54] *See supra* note 47.

included in the deferred taxes subject to the 10%/15% limitation calculations, and the related AOCI items would be adjusted on a net basis under the AOCI transition rules. In both cases, the calculation of the 10%/15% limitation amounts would be affected.

A simple example will serve to illustrate how we believe the two alternatives discussed above should function in practice. Assume a bank has CET1 of $1,000 at the end of 2014 before making any adjustment relating to items reported in AOCI. Assume further that in 2014 the bank has one AOCI item, an increase in value of $100 on available-for-sale securities whose cost was $200. The deferred tax associated with this item is a DTL of $35. When the Proposed Rules are fully in force in 2018, under this fact pattern, there would be no subsequent adjustment to CET1, and the DTL would enter into the calculation of deferred taxes subject to the 10%/15% limitation.

Under the transition rules for 2014, a bank that chooses to treat the AOCI item net would have the following results. It would reduce its CET1 of $1,000 to account for a portion of the increase in value of $100 in the available-for-sale securities. For 2014, the reduction would be 80% of the increase in value. On a net of tax basis, this adjustment would be (.80 x ($100 - $35)) $52. Accordingly, CET1 would be reduced to $948 ($1,000-$52), and this figure would be used in the 10%/15% limitation calculations. Because 20% of the increase in value is permitted to be included in CET1 in 2014, 20% of the deferred taxes, or (.20 x $35) $7, would be included in the deferred taxes subject to the transition rule for testing deferred taxes under the 10%/15% limitation.

Alternatively, a bank that chooses to treat the AOCI item on a gross basis would have the following results. It also would reduce its CET1 of $1,000 to account for the portion of the increase in value of $100 in the available-for-sale securities. However, in this case, the mark-down would be at 80% of the gross figure, or (.80 x $100) $80. The adjusted CET1 figure would then be ($1,000 - $80) $920, and this figure would be used in the 10%/15% limitation calculations. Because 100% of the deferred taxes was removed from the AOCI transition calculation, the full DTL of $35 would enter into the transition rule for calculating deferred taxes subject to the 10%/15% limitation.

Given the foregoing analysis, we request that the Basel III NPR be clarified regarding the proper treatment of AOCI items during the transition period to confirm that banks may make a periodic election either to net deferred tax effects (both DTAs and DTLs) against their associated assets and liabilities, or to include them in netting DTAs and DTLs on a pro rata basis against each other as provided in Section 22(e)(3). Moreover, the interplay of the transition rules for AOCI items and deferred tax items should be clarified as discussed above.

d. *Banks should be permitted to choose to gross up the DTLs embedded in the asset value of leveraged leases accounted for pursuant to the purchase accounting provisions in ASC paragraphs 840-30-25 through 35 as provided in the Current Rules.*

This issue also was discussed in the Prior DTA Letters.[55] We raise this point again in part in response to the Federal Reserve's request (page 52802 of the Preamble, Question 4) for comments or suggestions on adjustments that should be contemplated to mitigate or offset differences between IFRS and U.S. GAAP.

Under IFRS, there is no special accounting for acquired leveraged leases along the lines currently required under U.S. GAAP. Accordingly, when leveraged leases are acquired by a bank reporting under IFRS, deferred taxes are separately calculated based on the book-tax difference in the leased assets and are not taken into account in valuing the leases. The Clearing House's previous recommendation was designed to correct this disparity in treatment, like the Current Rules do now.

In the Prior DTA Letters, we pointed out that when the Current Rules were proposed, a commentator noted that the valuation of a leveraged lease acquired in a combination accounted for under purchase accounting gives recognition to the estimated future tax effects in valuing the remaining cash flows of the lease. Therefore, unlike in the case where an institution enters into a new leveraged lease, any future tax liabilities at the date of acquisition of the leveraged lease are included in the valuation of the leveraged lease (*i.e.*, they are not reported on the balance sheet as discrete DTLs). This purchase accounting provision has the effect of moving a target's leveraged lease DTLs into the carrying value of the leases themselves. The commentator suggested that banks therefore should be able to treat the future taxes payable included in the valuation of a leverage lease portfolio as DTLs in making their regulatory capital calculations. The Agencies agreed with the commentator. Accordingly, under the Current Rules, these DTLs are essentially re-recognized on a *pro forma* basis for regulatory capital, making them available to be offset against a bank's DTAs that the future taxable income could monetize. The Current Rules put U.S. banks in a position similar to competitors reporting under IFRS that are subject to limits on their DTAs, as their DTLs would never have been de-recognized under purchase accounting in the first place. This treatment would also be consistent with the principles behind the Basel III NPR's approach to the netting of deferred tax effects discussed in Part II.A.3.c.

[55] *See* page 6 in the Prior DTA Letter, dated September 19, 2011, and pages 6-7 in the Prior DTA Letter, dated December 13, 2011.

As we noted in the Prior DTA Letters, the Boards had tentatively agreed to converge the accounting for leases under U.S. and international accounting standards. Under the proposed changes, the U.S. GAAP purchase accounting treatment for leveraged leases would be eliminated for all leveraged leases, including existing leveraged leases. Since the time of the Prior DTA Letters, however, the Boards met on June 13, 2012, and further modified their earlier proposals.[56] The proposal to eliminate the U.S. GAAP treatment of leveraged leases likely will be maintained without any carveout for existing leases. If this happens, there may be no need for a special rule dealing with acquired leveraged leases. However, one cannot be certain what the effective date of the change may be, but we believe that any change will likely be several years in the future.

Prior to the effective date of any new rules on leveraged leases, we request that the current treatment under the Current Rules for leveraged leases be continued under the Basel III NPR.

4. <u>Significant and Non-Significant Investments in Financial Institutions</u>

a. *The definition of "financial institution" should be revised to encompass only "regulated financial institutions" as defined in the Proposed Rules and designated as SIFIs regulated by the Federal Reserve under Title I of Dodd-Frank.*[57]

Sections 22(c)(4) and 22(d) of the Proposed Rules would apply Basel III's limitations on "significant" and "non-significant investments" in capital instruments of unconsolidated financial institutions to U.S. banks. The NPRs define the term "financial institution" very broadly – much more broadly than was contemplated by the BIS when it initially proposed the rules that became Basel III. It includes companies engaged in a broad range of financial activities, irrespective of whether those companies are subject to regulatory capital requirements, as well as, among others, all "covered funds" as broadly defined for purposes of the Volcker Rule.[58]

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[56] *See* the Boards' joint project update on leases issued on June 19, 2012. *See* FASB, *Minutes of June 13, 2012, Joint Board Meeting* (June 19, 2012), *available at* http://www.fasb.org/cs/ContentServer?site=FASB&c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176160117106.

[57] This Part II.A.4.a is responsive to Questions 32 and 33 of the Basel III NPR.

[58] *See* Proposed Rules, § 2 (definition of "financial institution").

The BIS, when initially proposing limitations on investments in financial institutions in 2009, explained the rationale as follows:

> "The purpose of the proposed deduction is to remove the double counting of capital in the banking sector and limit the degree of double counting in the wider financial system . . . It will ensure that when capital absorbs a loss in one financial institution this does not immediately result in the loss of capital in a bank which holds that capital. This will increase the resilience of the banking sector to financial shocks and reduce systemic risk and procyclicality."[59]

The scope of entities included within the NPRs' definition of "financial institutions" is much broader than contemplated by the BIS' initial rationale. We strongly encourage the Agencies to re-define the term "financial institution" for purposes of the limitations on significant and non-significant investments in capital instruments of non-consolidated financial institutions to encompass only "regulated financial institutions" as defined in the NPRs[60] plus institutions supervised by the Federal Reserve under Title I of Dodd-Frank (that is, entities that become subject to regulatory capital requirements because they are designated as systemically important by the Financial Stability Oversight Council (the "**FSOC**") – a category of institutions that is included in clause (1)(i) of the Proposed Rules' definition of "financial institutions" but not included within their definition of "regulated financial institution").

Under Basel II, the scope of the definition of "financial institution" for purposes of determining which investments a bank should deduct from capital was a matter of national supervisory discretion.[61] The Agencies commented on their proposed definition that it is "designed to include entities whose primary business is financial activities and therefore could contribute to risk in the financial system, including entities whose primary business is banking,

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[59] BIS, *Strengthening the Resilience of the Banking Sector* (Dec. 2009), ¶ 101.

[60] The Advanced Approaches NPR defines the term "**regulated financial institution**" in order to implement the imposition of the Basel III Advanced Approaches' 1.25 multiplier to exposures to unregulated financial institutions regardless of size and regulated financial institutions with consolidated assets of $100 billion or more. Regulated financial institutions are defined to include "depository institutions, depository institution holding companies, non-bank financial companies supervised by the [Federal Reserve], designated financial market utilities, securities broker-dealers, credit unions, or insurance companies" – all entities subject to regulatory capital requirements.

[61] Basel II, Annex 1a, § C.

insurance, investing, and trading, or a combination thereof."[62] The foregoing language makes clear that the Agencies were attempting to address, through these provisions, a concern that is broader than the double counting of capital in the financial system contemplated by the BIS in 2009. Although financial regulation should address risks to the financial system broadly, we do not believe that it is necessary or prudent to expand the limitation on investments in unconsolidated financial institutions to address concerns other than double counting of capital in the banking system. In particular:

- If the Agencies intend with the more expansive definitions of the term "financial institutions" as used in the context of the 10%/15% limitation to address interconnectivity (and even if one accepts that interconnectivity was a meaningful contributor to the 2007-2009 crisis), these risks are being addressed by other laws and regulations. The cornerstone in this regard is Dodd-Frank § 165(e)'s single-counterparty credit limits and the regulations proposed thereunder, which themselves build on existing practices and standards (including lending limits) and other proposed regulatory reforms.

- If the Agencies intend to address the risk to a bank's capital by virtue of its holdings of capital instruments in unconsolidated financial institutions, those risks are addressed in any event through the risk weighting of equity exposures that are not deducted from CET1 in the Current Rules, as amended by the NPRs – most importantly, the 300% risk weighting of publicly traded securities and 400% risk weighting of non-publicly traded securities, after use of the limited "bucket" for insignificant investments in unconsolidated financial institutions up to 10% of the investing bank's Tier 1 capital.

Several of the sub-components of the definition of financial institution do not seem sensible or necessary in any event, even in the context of interconnectivity. For example:

- *Companies Predominantly Engaged in Financial Activities:* Clause 1(v) of the definition of "financial institution" would generally cover a wide range of financial entities, including entities subject to regulatory capital requirements (such as broker dealers and insurance companies) and those generally not subject to regulatory capital requirements (such as loan originators and servicers). Unless an entity is subject to regulatory capital requirements,

[62] Basel III NPR, at 52,820. We note, however, that engaging in financial activities in and of itself does not necessarily contribute to risk in the financial system any more than any other aspect of the economy that is reliant on the financial system.

subjecting an investment in that entity to the 10%/15% limitation or limitations on non-significant investments in unconsolidated financial institutions would not further the goal of eliminating double counting in the financial system. This clause of the definition also would not appear meaningfully to further the Agencies' apparent objective of reducing interconnectivity in view of the numerous other safeguards in place that address this risk, including those discussed above. For example, the BIS' G-SIB capital surcharge purports to address this risk given that "interconnectedness" is among the indicators used to determine systemic importance and ultimately the magnitude of the surcharge. Moreover, we believe it is particularly inappropriate to include entities predominantly engaged in asset management activities within the definition of a "financial institution" based on potential interconnectivity concerns given that the FSOC has not determined whether, or how, asset management firms may pose a threat to financial stability.[63]

- *Covered Funds*: Clause 1(iii) of the definition of financial institution would include "an entity that is a covered fund for purposes of section 13 of the Bank Holding Company Act . . . and regulations issued thereunder." This refers to the so-called "Volcker Rule"[64] that was added by Dodd-Frank and technically became effective on July 21, 2012, subject to applicable regulatory guidance. The Volcker Rule imposes restrictions on sponsoring, investing in and transacting with hedge funds and private equity funds.[65] It defines "hedge fund" and "private equity fund" broadly, and synonymously, as any issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the "**1940 Act**"), but for Section 3(c)(1) or 3(c)(7) of the 1940 Act and such similar funds as the appropriate Agencies, the SEC or the CFTC may, by rule, determine.

  We do not understand why there should be any relation between Volcker Rule designation and application of special capital rules for loans to such designated entities. The legislative history, and the actual record, are bereft of any suggestion that investments by banks in covered funds in any way attributed to

[63] *See* 77 Fed. Reg. 21,644 (Apr. 11, 2012).

[64] Dodd-Frank, § 619.

[65] The Volcker Rule requires the Agencies, the SEC and CFTC to engage in various rulemakings. In October 2011, the Agencies and the SEC issued a notice of proposed rulemaking to implement the substantive provisions of the Volcker Rule. The CFTC issued a substantially similar proposal in January 2012.

the financial crisis. In any event, we believe that the application of highly stringent capital requirements are particularly inappropriate in two instances.

First, the Volcker Rule provides an exemption from the restrictions on sponsorship and investment for "organized and offered funds" that satisfy a number of conditions, including that a subject banking entity's aggregate interest in all such funds must be "immaterial" to the banking entity and in no event more than 3% of the banking entity's Tier 1 capital. Investment in these funds are also subject to a deduction from Tier 1 capital. Under the proposed implementing rules, interests in covered funds subject to this capital deduction under the Volcker Rule will not be subject to an overlapping deduction requirement under Basel III.[66]

Second, because the very broad definition of hedge funds and private equity funds under the Volcker Rule could include a wide array of entities that rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act that are not traditionally thought of as hedge funds and private equity funds, such as joint ventures, securization SPEs, other special purpose vehicles and other entities that rely on these exceptions under the 1940 Act, the Agencies, the SEC or the CFTC included carveouts for these entities (and, we expect, are considering additional carveouts based on comment letters they have received on the Volcker Rule) under the proposed implementing rule. However, the Volcker Rule defines even these exempt entities as "covered funds." Accordingly, they would be financial institutions for purposes of the 10%/15% limitation and the limitations on non-significant investments in unconsolidated financial institutions.

We do not believe it is appropriate or necessary to subject all covered funds to the limitations on investments in unconsolidated financial institutions by including them in the definition of "financial institution." The Volcker Rule already separately addresses the capital treatment of investments in certain of these funds and there will almost certainly be a series of carveouts for a variety of entities that are not truly covered funds. Further, subjecting all covered funds to these limitations does not appear to meaningfully further the objective of

[66] The Agencies have indicated that they intend to avoid prescribing overlapping regulatory capital requirements for the same exposures. *See* Basel III NPR at 52,824. Therefore, once the regulatory capital requirements prescribed by the Volcker Rule are finalized, the Agencies expect to amend the regulatory capital treatment for investments in the capital of an unconsolidated financial institution – currently set forth in Section 22 of the Proposed Rules – to include the deduction that would be required under the Volcker Rule. *Id.*

eliminating double counting or reducing interconnectedness risk for the reasons described above.

- *Commodity Pools*: Clause 1(ii) of the definition of "financial institution" would include commodity pools as defined in Section 1(a)(10) of the Commodity Exchange Act. The Commodity Exchange Act defines "commodity pool" broadly to include any investment trust, syndicate, or similar form of enterprise that is "operated for the purpose of trading in commodity interests."[67] Given the breadth of this definition and the fact that the CFTC's staff has at times interpreted the term "commodity interest" very broadly, arguments may be made that a commodity pool could encompass registered mutual funds, exchange traded funds, investment companies that qualify for exemptions other than Section 3(c)(1) or 3(c)(7) of the 1940 Act, and even non-financial companies that fall outside the definition of "investment company," if they trade in "commodity interests." For similar reasons to those expressed above, we believe that this category should be eliminated entirely and that this elimination should not give rise to concerns of "double counting" capital or "interconnectedness" risks.

Exposures to the types of entities that are currently defined as "financial institutions" under the Proposed Rules but that we believe should be carved out of the definition are, of course, risk-weighted in the normal way. As noted above, equity exposures would still be subject to the more severe capital requirements applicable to equity exposures – risk weights of 100% for the limited "non-significant" bucket of equity exposures generally up to 10% of total capital and then either 300%, 400% or 600% – risk weights that have been increased as compared to the current existing general risk-based capital rules (and given further effect by the Collins Amendment's floor requirements) in the Standardized Approach NPR. Equity exposures are thus further penalized in any event.

Simply put, the broad definition of "financial institution" proposed in the Basel III NPR is not necessary to eliminate double-counting of capital in the financial system, and the other pending reforms discussed above deal with perceived interconnectivity issues among financial firms in a more direct manner. It is not, in our view, sensible to discourage investments in certain entities indirectly through capital regulation in order to address risks that are already being thoroughly addressed through other more direct means.

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[67] *See, e.g.*, Letters from ASF to the Agencies, the SEC, and the CFTC, dated February 13, 2012, April 13, 2012, July 27, 2012, and August 23, 2012, addressing the impact of the Volcker Rule on the securitization market.

In addition, the combination of (i) the proposed definition of "financial institutions" and, most particularly, clause 1(v) thereof, which seeks to capture companies engaged primarily in financial activities (as discussed above), and (ii) the requirement that, when determining their investments in unconsolidated financial institutions, banks "include direct, indirect and synthetic exposures to capital instruments,"[68] creates significant practical difficulties in how banks would need to calculate the applicable minority interest deduction for purposes of their capital ratios. When these two components of the Proposed Rules are read together, a bank would need to examine each entity in which it has an investment or to which it has a synthetic exposure (including through a derivative or an index) in order to determine whether any such entity is a financial institution as defined, including because it is predominantly engaged in financial activities under the multi-prong test set forth in the Proposed Rules. This would certainly be a complex and burdensome exercise even if the exposure were to a public reporting company under the Securities Exchange Act of 1934, and even then, it may not always be possible to reliably make such a determination based on publicly available information. With respect to a foreign or a private company, such a task is likely to be even more problematic as information may not be readily available to make such a determination.

However, the required inquiry and analysis would not stop there because the bank would also need to determine whether it has any "indirect" exposure to a financial institution. As a result it would appear to be required to determine whether any entity to which it has a primary investment, in turn, has an investment in one or more financial institutions and so on, *ad infinitum*. Such an extended inquiry would not only be exceedingly burdensome but also next to impossible to complete as a practical matter. We also note that the same practical difficulties arise when attempting to determine the deduction for investments in a bank's own capital instruments.

In light of the foregoing, we respectfully urge the Agencies to eliminate the requirement that banks look-through investments in order to determine whether they have indirect exposures to other financial institutions or their own equity securities. This requirement is simply extremely burdensome and ultimately unworkable, and offers limited additional benefit from a systemic perspective. Although intellectual purity might point to deduction of these exposures as the Proposed Rules require, the magnitude of these indirect exposures is likely *de minimis* from a systemic perspective and does not warrant the effort required for a literal and, in any event, likely futile quest for complete compliance with the Proposed Rules.

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[68] Basel III NPR, at 52,821.

In addition, the Proposed Rules should be clarified to explicitly avoid literally requiring double counting of deductions for minority investments in financial institutions. For example, if a bank has a minority investment in financial institution A, which in turn has a minority investment in financial institution B, the Proposed Rules could be read as to require the bank to calculate the deduction *vis-à-vis* both financial institution A and financial institution B, thus double counting the potential exposure to a financial institution because economically its exposure to financial institution A subsumes and includes its exposure to financial institution B.

b. *Trading book exposures should be calculated based on deltas, as required by the Amended Market Risk Rules, or failing that, the Agencies should consider other changes to reflect the true nature of trading book exposures, such as decreasing the residual maturity requirement for short positions in the trading book, exempting positions in broad market indices, and exempting physically-settled equity derivatives*.

We are also concerned that the Proposed Rules apply to exposures to the capital of unconsolidated financial institutions in both a bank's banking book and trading book.[69] Specifically, a "net long position" in the capital of an unconsolidated financial institution is defined as the gross long position, "net of short positions in the same exposure where the maturity of the short position either matches the maturity of the long position or has a residual maturity of at least one year."[70] Although this exposure calculation may be appropriate for longer-term, more traditional banking book investments, we do not believe the maturity matching restrictions are appropriate for market-making related activities in the trading book, which is substantively different in nature and risk profile, and, in fact, the restrictions contradict the requirements of the Amended Market Risk Rules.

Banks that make markets in equities must be willing to take the other side of their clients' positions. As they engage in a variety of transactions to facilitate client demand, banks take on risk, in both short and long positions. Banks will seek to hedge these risks with

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[69] Banking book positions are those that are not covered positions for the Amended Market Risk Rules. Trading book positions, which are covered positions under the Amended Market Risk Rules, "include assets that are in the trading book and held with the intent to trade," or more specifically, trading assets and trading liabilities that are trading positions, that is, 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. 77 Fed. Reg. 53,060, 53093 (Aug. 30, 2012) (the rules set forth therein, the "**Amended Market Risk Rules**").

[70] Proposed Rules, § 2.

offsetting long and short positions, sometimes with perfectly matching maturities, but often not.

For example, if a pension fund wanted to make an investment of $100 in a particular financial institution stock, it could do so via a long swap position in that stock with a set maturity – say six months for purposes of this example. The bank on the other side of the transaction would then hold a $100 short swap position in that stock with a six-month maturity. To hedge its short risk, the bank could choose one of many strategies to prudently risk manage itself, including buying $100 of the stock or entering into a long derivative position that generated $100 in synthetic exposure such as a future, an offsetting equity swap, or a synthetic forward. However, for the purpose of the financial institution deduction, the bank would have to include a $100 net long position in the stock, because the maturity of the short does not perfectly match that of the long position, nor is its residual maturity over one year.

The deduction, as proposed, would undermine banks' ability to prudently risk manage their market-making activity, as it would be more capital efficient for a bank to hedge, for example, a four-month long financial institution exposure with a one-year short position than a five-month short position, despite the higher basis risk associated with the one-year short. Perversely, a bank that chose to hedge its four-month long financial exposure with a short five-month position could see a negative impact to capital, compared to a different institution that remained unhedged on the same position despite the unhedged position carrying far more economic risk. This result is clearly contrary to prudent capital regulation and sound public policy.

We urge the Agencies to account for the nature of market-making activity in the application of the financial institution deduction. Market-making positions are typically in a bank's trading book. In practice, and as required by the Amended Market Risk Rules for institutions subject thereto, banks manage market risk based on delta adjusted exposures,[71] which allows aggregation of exposures at a portfolio level of products with nonlinear pay-offs and delta one products. Deltas are a well-understood concept used in the measurement of risks within the trading book; the value of a derivative is a function of its delta, which, in cases of nonlinear pay-offs, is partially a function of the time-to-maturity. Deltas are a risk- and time-

[71] According to the Amended Market Risk Rules, "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)." 77 Fed. Reg. 53,060 (Aug. 30, 2012), at 53,073.

sensitive measure of exposure that much more accurately reflects risk than the Proposed Rules' derivation of a net long position.[72]

Not only do the Amended Market Risk Rules require the use of deltas to calculate exposures for trading book positions, but they also require that such positions are short term in nature. With the financial institutions deduction, as proposed, the Agencies are, in effect, discouraging banks from holding short equity positions with a residual maturity of under one year in the trading book, regardless of whether these positions are hedges to long positions, or are risk-taking positions to facilitate client transactions. This could not only raise transaction costs for bank customers, but it would directly conflict with the spirit and requirements of the Amended Market Risk Rules.

We also note that Proposed Rules do not take into account that equity markets are some of the deepest, most liquid markets; even at the height of the 2008 financial crisis, market makers and their clients bought and sold, hedged and rehedged their equity positions at high volumes.

Given the significant flaws in the proposed definition of exposure to a financial institution in the context of the trading book, we recommend that the Agencies modify the methodology with respect to "exposure" for trading book exposures.

We believe that trading book exposures should be calculated based on deltas, as is required by the Amended Market Risk Rules, or failing that, the Agencies should consider other changes to reflect the true nature of trading book exposures, such as decreasing the residual maturity requirement for short positions in the trading book, exempting positions in broad market indices, and exempting physically-settled equity derivatives.

[72] Delta is a key risk measure of sensitivity of an instrument's price to movements in the price of its underlier(s). For certain products such as stocks, futures, and equity swaps, the delta is one and remains so for the life the trade. However, for other products such as options, the delta can vary between zero and one, depending on the residual maturity of a derivative. For example, the delta of an out-of-the-money call option with a spot price of 50 and a strike price of 80 would vary depending on the maturity date of the call option. At a 1-day maturity, the delta would be close to zero, as there is a low likelihood that the stock price will rise to 80 in one day. But if the maturity of the call option were longer, the delta would be closer to one, because the probability would be higher that the stock price could move to 80. The delta of a derivative whose payout is linked directly to stock price movements (like an equity-linked swap) is 1, given the changes in the payout of the derivative will move in lock-step with changes in the underlying stock price.

**B. The application of the minority interest limitations on Additional Tier 1 and Tier 2 capital instruments issued by depository institution subsidiaries of bank holding companies and real estate investment trust ("REIT") preferred and similar securities is inappropriate in the U.S. context.[73]**

Section 21 of the Proposed Rules places significant limits on the amount of Additional Tier 1 and Tier 2 capital issued by consolidated subsidiaries of a bank holding company and held by third parties that can be included in the capital of the parent bank holding company. The preamble to the Basel III NPR indicates that this formulaic limitation also extends to non-cumulative perpetual preferred securities issued by REIT subsidiaries of banks that are exchangeable, at the option of the applicable Federal bank regulator in the event the relevant depository institution experiences significant capital problems, into non-cumulative perpetual preferred stock of the parent bank or bank holding company. The formulaic limitation embodied in Section 21 can be quite severe – for example, prohibiting the recognition of up to approximately 96% of the minority interest capital in the case of typical REIT preferred securities held by third parties.

1. <u>The limitation on the recognition of Additional Tier 1 and Tier 2 capital issued by depository institution subsidiaries would serve to significantly curtail a unique and important source of cost-effective funding for U.S. banks and should be eliminated for these instruments.</u>

The typical organizational structure of U.S. banks (consisting of a public bank holding company with one or more wholly owned depository institution subsidiaries) generally is different from the typical organizational structure in many other countries where the top level organization and the depository institution are one and the same. A U.S. depository institution subsidiary can often issue capital securities at a more cost-effective rate relative to its parent. For example, the spread differential between Tier 2 subordinated debt issued by a bank subsidiary and the same debt issued by its holding company can be 25 basis points or more. When coupled with the exemption from the registration requirements under Section 3(a)(2) of the Securities Act of 1933, this has led to the existence of approximately $105.5 billion[74] of issued and outstanding Additional Tier 1 and Tier 2 capital instruments of U.S. depository institution subsidiaries of parent bank holding companies. The imposition of Section 21's limitation on such instruments would serve to significantly curtail depository institution-level issuances of these securities in the future as parent bank holding companies, and in particular,

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[73] This Part II.B is responsive to Questions 26 and 27 of the Basel III NPR.

[74] Based on SNL Financial market data as of July 2012.

those with multiple depository institution subsidiaries and/or material operations at the holding company level, may no longer find it efficient (on a consolidated basis) to issue Additional Tier 1 and Tier 2 capital instruments at the depository institution level given the minority interest limitation, thereby losing the benefit of the aforementioned cost effectiveness of such issuances. Thus, Section 21's limitation will have the perverse effect of discouraging depository institutions from raising their own capital or increasing the cost of Tier 2 sub-debt for the institution on a consolidated level. We respectfully submit that neither of these results makes sense from a public policy perspective in light of the U.S.'s holding company and depository institution organizational model for financial institutions. Although we acknowledge that cross-holdings or non-controlling investments in depository institutions may raise certain policy concerns, those issues are not presented by wholly-owned depository institution subsidiaries.

In addition, the minority interest rules as applied to capital issued by depository institution subsidiaries are overly punitive for another reason. It is likely banks will target all of their Basel III capital ratios, at both the depository institution and consolidated level, at a prudent level over the minimum requirement plus buffers – assume 150 basis points for purposes of this illustration. To achieve this result, it is also likely such "excess" capital will be in the form of CET1, such that the bank's CET1 ratio in this illustration would be 8.5%, or 150 basis points over the 7.0% effective minimum. Thus, the bank would have 150 basis points "worth" of Tier 1 capital, and 200 basis points of Tier 2 capital so that all three risk-based ratios would be 150 basis points over their respective effective minimums. Again using Tier 2 sub-debt as the illustration, the example bank would therefore have a total capital ratio of 12.0%, with Tier 2 capital equal to the 200 basis point difference between the 10.5% Total Capital and 8.5% Tier 1 capital minimums plus Capital Conservation Buffer amounts. In this example, the depository institution therefore has no "excess" Tier 2 capital. However, for purposes of the minority interest calculations, the 12.0% "stated" Total Capital ratio is currently compared to the 10.5% minimum plus Capital Conservation Buffer requirement, therefore concluding that "excess" Total Capital exists. This assumed "excess" is the primary driver that disallows depository institution-level sub debt, and potentially other forms of depository institution-issued Additional Tier 1 or Tier 2 securities, from Basel III capital.

Furthermore, the health of its subsidiary depository institution(s) is, as a practical matter, a *sine qua non* requirement for the health of the parent holding company for most U.S. banks. From a prudential and supervisory perspective, the preservation of a robust and cost-effective market for Additional Tier 1 and Tier 2 capital instruments for depository institutions would therefore serve to enhance the overall health of the bank holding company, and promote the goals of consolidated supervision.

Thus, we urge the Agencies to exclude Additional Tier 1 and Tier 2 capital instruments issued by depository institution subsidiaries from the minority interest limitation embodied in Section 21 of the Proposed Rules. We believe this exclusion is particularly justified because the importance of these instruments is a result of the unique structure of the U.S. banking system and a deviation from the international Basel III standards would therefore be appropriate. Moreover, from a policy perspective, regulatory requirements should not disadvantage cost-effective capital sources while simultaneously mandating higher levels of capital in the system.

2. <u>REIT preferred and similar securities should not be subject to the minority interest limitations because they do not, by virtue of their exchange feature, pose the same loss absorbency issues as other forms of minority interests, while simultaneously preserving the only presently available tax-deductible Additional Tier 1 instrument for U.S. banks.</u>

The Basel III NPR preamble states that the limitation on minority interests set forth in Section 21 is based on concerns that "capital issued by consolidated subsidiaries . . . does not always absorb losses at the consolidated level."[75] However, as the preamble also recognizes, non-cumulative perpetual REIT preferred and similar securities[76] also contain a crucial feature whereby "the primary federal supervisor may direct the bank in writing to convert the REIT preferred shares into noncumulative perpetual preferred stock of the bank"[77] in the event of significant capital problems at or conservatorship or receivership[78] of the relevant depository institution subsidiary.

In light of this exchange feature, we believe that it is not appropriate to subject REIT preferred and similar securities to the minority interest limitations of Section 21 of the Proposed Rules. Simply put, the exchange feature ensures that the REIT preferred and similar securities will be there to "absorb losses at the consolidated level" and therefore there appears to be no analytical justification for treating securities having this exchange feature as subject to

[75] Basel III NPR, at 52,815, 52,816.

[76] Similar securities involving a limited liability company subsidiary (that elects to be treated as a partnership for U.S. federal income tax purposes), typically a REIT have a substantially similar structure and produce the same tax-related consequences. In addition, we note that these limited liability companies are not themselves REITs under the Internal Revenue Code of 1986, as amended (the "**Code**"), and therefore are not required to distribute 90% of their income in order to maintain their REIT status. As such, the so-called "consent dividend" provisions discussed in the Basel III NPR in connection with REIT preferred securities are not applicable analytically in the context of these alternative structures.

[77] Basel III NPR, at 52,817.

[78] *Id.*

minority interest limitation rules. Thus, we believe that not subjecting this type of REIT preferred and similar instruments to the minority interest limitations would be entirely consistent with the international Basel III standards and would not, in fact, actually constitute a deviation therefrom.

In addition, the Basel III NPR's requirement that Additional Tier 1 capital be perpetual[79] precludes all currently available instruments except REIT preferred and similar securities from being tax-deductible under the Code. We understand this is not the case in many European and other jurisdictions where applicable tax regimes permit the tax deductibility of perpetual instruments in certain circumstances. Given the severe potential limitations placed on REIT preferred and similar securities – for example, limiting the inclusion of up to approximately 96%[80] of such instruments in the top tier holding company's regulatory capital, the application of Section 21 to these instruments could effectively eliminate the only source of tax-advantaged Additional Tier 1 capital for U.S. banks, thereby placing them at a comparative disadvantage *vis-à-vis* institutions in jurisdictions with a different tax regime.

Finally, we recognize that the events of 2008 may have raised questions concerning the potential effectiveness of the REIT preferred exchange mechanics in certain isolated and fact-specific circumstances. We respectfully submit that the proper supervisory response to such perceived issues is not to broadly submit these instruments to the minority interest limitation but rather to focus on ensuring that the exchange mechanics are properly implemented and, if advisable, revised in order to ensure the effectiveness of the exchange as a substantive legal and economic matter.

### C. The regulatory capital components – common equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital – defined in Section 20 of the Proposed Rules require modification to accommodate U.S. corporate law and practices.[81]

The Proposed Rules, read literally, would disqualify virtually all of the common stock and preferred stock of U.S. banks as CET1 and Additional Tier 1 capital, respectively. The Proposed Rules require modification to accommodate U.S. corporate law and practice, as discussed below. We do not believe these modifications detract from the strength of the capital components for U.S. banks.

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[79] *See* Proposed Rules, § 20(c).

[80] Based on *pro forma* calculations of some of our members.

[81] This Part II.C is responsive to Question 15 of the Basel III NPR.

1. CET1.

The terms of common stock for a U.S. bank, whether a bank holding company or a depository institution, are established by law – for example, the Delaware General Corporation Law (the "**DGCL**") for a bank holding company incorporated in Delaware or the National Bank Act or state banking law for a depository institution.[82] The terms are not created by contract. A bank has only limited ability to modify the terms of its common stock in its certificate of incorporation, articles of association or other charter document. The Proposed Rules' elements addressing CET1 must be revised to accommodate ordinary common stock of U.S. banks issued under these banking laws. In order to provide context for our comments, we will focus on the elements in Section 20(b)(1) of the Proposed Rules as applied to a Delaware bank holding company.

Three elements in Section 20(b)(1) are inconsistent with the DGCL as applied to common stock of a Delaware bank holding company:

- Clause (v) addresses cash dividends and provides that cash dividends "are paid out of the [BANK]'s net income and retained earnings and are not subject to a limit imposed by the contractual terms governing the instrument." For a Delaware bank holding company, DGCL § 170 addresses the payment of dividends (for both common stock and preferred stock) and provides that a Delaware corporation's board of directors may declare and pay dividends either (1) out of surplus or (2) if there is no surplus, out of net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year. Surplus is defined in DGCL § 154 as capital surplus. The DGCL does not limit dividends to net income and retained earnings or define an illegal dividend by reference to those terms; instead, its test is fundamentally a prohibition against a dividend that invades capital (*i.e.*, a dividend that exceeds capital surplus and, as a consequence, if paid would result in an invasion of stated capital). We urge the Agencies to delete clause (v) from Section 20(b)(1) and, insofar as dividends are concerned, rely, as they have in the past, on the interplay between statutory limitations on dividends (*e.g.*, the DGCL for a Delaware bank holding company and Sections 55 and 56 of the National Bank Act for a national bank) as well as applicable regulatory limitations on dividends (*e.g.*, for all bank holding companies the supervisory guidance in the Federal Reserve's SR Letter 09-4 and related interim guidance in November 2010, and, for bank holding companies

[82] We note that many state corporate laws are modeled on the DGCL and, thus, the conflicts discussed below between the Proposed Rules and the DGCL also exist with respect to a number of other state corporate laws.

having $50 billion or more in total consolidated assets, the limitations of the Capital Plan Rule, for depository institutions the prompt corrective action provisions of the Federal Deposit Insurance Act and the Agencies' regulations thereunder, and for all banks after giving effect to the rules that would be adopted pursuant to the NPRs, the Capital Conservation Buffer requirements).[83]

- Clause (vii) provides that dividends and other capital distributions may be paid "only after all legal and contractual obligations of the [BANK] have been satisfied, including payments due on more senior claims." There is no provision in the DGCL or, we believe, U.S. corporate law more generally requiring these provisions. The terms are exceedingly vague and broad, *e.g.*, what is a "more senior claim" for this purpose and does it include trade creditors and other vendors? How would a bank's board of directors satisfy itself that absolutely no "more senior claim" is due and unpaid? Read literally, any contractual obligation is a "more senior claim." Moreover, disputes as to payment obligations between parties inevitably occur. Clause (vii) should be deleted. Although subordination is a relevant and key concept for common stock, it should not be applied (and is very impractical to apply) to on-going payments of dividends as compared to other payments (whether servicing indebtedness or paying trade or other creditors); instead, its primary relevance is in a receivership, insolvency, liquidation or similar proceedings, which is addressed in clause (viii).

- Clause (iii) in Section 20(b)(1) provides that, in order to qualify as CET1, the instrument "can only be redeemed . . . with the approval of the [AGENCY]." Although substantively appropriate, the terms of common stock as established by applicable corporate law and charter documents will not themselves include that limitation. The Agencies should address the requirement for prior approval of redemptions or repurchases by deleting the quoted language from clause (iii) and adding, at the end of Section 20(b)(1), a free standing sentence that simply states the regulatory requirement – *i.e.*, "a [BANK] may not redeem via discretionary repurchases an instrument included in common equity Tier 1 except with the prior approval of the [AGENCY]."

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[83] We appreciate that, by urging the Agencies to delete clause (v), we are also urging that the provision that dividends "are not subject to a limit imposed by the contractual terms governing the instrument", quoting the language at the end of clause (v), be deleted. We are not certain what the Agencies intend to capture with that language. Read literally, it would seem to preclude a bank from agreeing in a credit agreement with lenders not to pay dividends if a specified financial test was breached.

2. Additional Tier 1 Capital.[84]

After giving effect to the NPRs and the expiration of phase-ins, the only readily-apparent instrument issuable by a U.S. bank (whether a bank holding company or depository institution) that would qualify as Additional Tier 1 capital is non-cumulative perpetual preferred stock.[85] The terms of preferred stock, like common stock, are established by applicable corporate law (*e.g.*, the DGCL for a Delaware bank holding company and the National Bank Act or state banking law for a depository institution) and, to the extent permitted by the applicable corporate law, the certificate of incorporation or other charter document of the bank, giving effect for most banks to the right of the board of directors to establish the initial terms for preferred stock by resolution that, when filed with the Secretary of State or other relevant office, becomes a part of the bank's certificate of incorporation or other charter documents.

Clause (viii) of Section 20(c)(1) applies to Additional Tier 1 capital, including preferred stock, the same requirement that appears in clause (v) of Section 20 (b)(1) for CET1 – that dividends may only be paid out of net income and retained earnings. It should be eliminated as applied to preferred stock for the same reasons discussed in Part II.C.1 in the context of CET1 – it is inconsistent with corporate law and, insofar as prudential concerns and supervision of dividends are concerned, is addressed in other regulations.

We urge the Agencies to make three additional modifications to the elements for Additional Tier 1 capital in Section 20(c)(1):

- At the end of clause (vii), we request that the Agencies add the phrase "or of other Additional Tier 1 capital instruments ranking as to dividends on a parity with or junior to the instrument being evaluated for purposes of this clause (vii)." The reason for this requested modification is that clause (vii) as written would preclude two customary terms of non-cumulative perpetual preferred stock that are required by investors and are not inconsistent with the position of such instrument in a bank's capital structure: (x) the requirement that, if a bank chooses to pay only a partial dividend on a series of non-cumulative perpetual preferred stock, it may not pay during the same period more than a pro rata

[84] This Part II.C.2 is responsive to Questions 9 and 18 of the Basel III NPR.

[85] The other instruments issued by U.S. bank holding companies that, prior to the Collins Amendment and Basel III, qualified as non-common Tier 1 capital are limited amounts of cumulative perpetual preferred stock and trust preferred securities. Because of Basel III's and the Collins Amendment's prohibition on cumulative instruments as a component of Additional Tier 1 capital, neither of those instruments will qualify going forward, as recognized by the NPRs.

partial dividend on any other outstanding series of preferred stock that ranks on a parity with the first series as to dividends; and (y) flexibility for a bank to include in its capital structure series of preferred stock that have different rankings as to dividends and/or upon liquidation (*i.e.*, both senior preferred stock and junior preferred stock). Without modification, clause (vii) would disqualify as Additional Tier 1 capital preferred stock that includes the customary requirement for parity dividends if less than full dividends are paid (because the bank's "full discretion . . . to cancel dividends" would be restricted by the parity dividend provisions in other outstanding series of preferred stock); it would also preclude banks from issuing both senior and subordinate preferred stock (because the dividend limitation as to senior preferred stock would need to be implemented by reference not just to capital distributions to holders of common stock but also by reference to capital distributions to holders of junior preferred stock).[86]

- The redemption provision in clauses (v) and (vi) are redundant and, because of their redundancy, confusing. We urge the Agencies to:
  - delete clause (vi);
  - amend clause (v)(A) to read: "The [BANK] must receive prior approval from the [AGENCY] to redeem or repurchase the instrument."; and
  - amend the introductory phrase in clause (v)(C), which currently reads "Prior to exercising the call option" to read "Prior to redeeming or repurchasing the instrument."
- Clause (x)'s requirement that the instrument be treated as equity under U.S. GAAP would likely preclude inclusion in Additional Tier 1 capital of any contingent capital instrument that may otherwise be issuable by U.S. banks and find market acceptance, even if the instrument meets the other criteria for Additional Tier 1 capital. We and our members have discussed with the Agencies on a number of occasions during the last several years the challenges for U.S. banks in devising contingent capital instruments having the types of characteristics that the Basel Committee has contemplated. Those challenges

[86] We note that the BIS confirmed in a document addressing frequently asked questions arising under the Basel III capital framework that dividend stoppers on securities other than common stock are permitted. BIS, *Basel III Definition of Capital – Frequently Asked Questions* (question 3, ¶¶ 54-56).

> arise out of U.S. tax law considerations as well as investment limitations on the investor classes that would purchase these instruments. However, were U.S. banks to develop an acceptable instrument, the instrument likely would initially be classified as debt instead of equity for U.S. GAAP purposes. In order to accommodate this possibility, we urge the Agencies to revise clause (x) to read: "Except as otherwise approved by the [AGENCY], either through interpretive guidance or specifically in the case of a particular instrument, the paid-in amount is treated as equity under U.S. GAAP."

Finally, we do not support a requirement that preferred stock included in Additional Tier 1 capital permit a penny dividend to common stockholders for banks subject to a maximum payout ratio of zero. Our most significant concern with inclusion of such a provision is that it would create a bifurcated market, with investors pricing more favorably outstanding series of preferred stock that do not include the provision versus newly-issued series that do. Moreover, we believe that a careful comparative analysis of the trading prices during the financial crisis of common stock of banks that reduced common stock dividends to one penny per share versus those that stopped paying dividends altogether does not demonstrate a meaningful benefit of retaining the ability to pay a dividend of one penny per share.

3. Tier 2 Capital.[87]

Our technical, yet important, comments concerning the elements of Tier 2 capital as set forth in Section 20(d) of the Proposed Rules are as follows:

- The redemption provisions in clauses (v) and (x) are redundant in the same manner that the provisions applicable to Additional Tier 1 capital, discussed above, are redundant. We urge the Agencies to implement the same corrections – that is, delete clause (x) and revise clause (v) in the same manner that we have suggested the Agencies revise clause (v) of Section 20(c).

- The most common Tier 2 capital instrument issued by U.S. banks is subordinated debt. Because of tax considerations, the subordination provisions in subordinated debt issued by U.S. banks customarily specify that the class of "senior creditors" whose claims rank prior to those of holders of the subordinated debt does not include trade creditors, and the Agencies have accepted that provision. Accordingly, we request that the Agencies insert in clause (ii), after the phrase "general creditors", a parenthetical phrase reading

[87] This Part II.C.3 is responsive to Question 21 of the Basel III NPR.

"(other than trade creditors)." In addition, while many existing bank holding company level subordinated debt indentures contain subordination provisions concerning borrowed money, similar obligations arising from off-balance sheet guarantees and direct credit substitutes, and obligations associated with derivative products such as interest rate and foreign exchange contracts, commodity contracts, and similar arrangements, they may not contain a general subordination provision with respect to "general creditors" of the holding company *per se*. Thus, the Proposed Rules should be modified to only have prospective application in this respect.

- Trust preferred securities that qualify as Tier 1 capital under the Federal Reserve's existing general risk-based capital rules have been acknowledged by the Federal Reserve to qualify as Tier 2 capital to the extent that the amount of the bank holding company's trust preferred securities exceeds the amount permitted to qualify as Tier 1 capital under the existing rules. We believe that, going forward, notwithstanding the phase out of trust preferred securities as a component of Additional Tier 1 capital, trust preferred securities that are not includible in Additional Tier 1 capital should qualify as Tier 2 capital. Qualifying trust preferred securities must have a minimum interest deferral period of five years (with many providing for ten years of interest deferral), with holders or a trustee on their behalf having the right to accelerate payment of principal if interest is not made current by the end of the deferral period. The provision in the proposed rules that raises a question in this regard is clause (vi)'s limitation on acceleration except in the event of a receivership, insolvency, liquidation, or a similar proceeding. The same issue arises under existing rules because the existing rules include the same limitations on acceleration for Tier 2 qualification. The Federal Reserve historically has taken the view that the minimum five-year interest deferral period in qualifying trust preferred securities is equivalent to a minimum five-year term and, accordingly, excess trust preferred securities may be included in Tier 2 capital but that the inclusion of trust preferred securities in capital begins to amortize on a pro rata basis (20% per year for instruments with a five-year deferral period and 10% per year for instruments with a ten-year deferral period) once the bank holding company begins deferring payment of interest; and hence acceleration for non-payment of interest at the end of the deferral period is the equivalent of the obligation to pay principal at maturity. We request that the Agencies accommodate trust preferred securities as Tier 2 capital by revising the "except" provision at the end of clause (vi) to read as follows: "except (x) in the event of a receivership, insolvency, liquidation, or similar proceeding of the [BANK] or (y) if the instrument includes a right on the part of the [BANK] to defer payment of interest for at least five years with a contractual right of holders or a trustee on their behalf to accelerate payment of principal or interest on the instrument at the end of the deferral period if interest has not been made current by the end of the deferral period for such acceleration right."

4. Additional Comment on Regulatory Capital Components.

Clause (1)(v) in each of Sections 20(c) and 20(d) limits the special events that may entitle a bank to redeem an Additional Tier 1 capital or Tier 2 capital instrument early to regulatory capital events and tax events. Many outstanding instruments also include early call rights for an "Investment Company Act Event" or a "Rating Agency Event," defined (generally described) as the issuer losing its entitlement to an exemption from status as an investment company under the 1940 Act or a change in a rating agency's recognition of the capital strength of the particular instrument, respectively. The securities that most commonly include these provisions are trust preferred securities. Although we do not believe exceptions for these additional special events are necessary for newly-issued instruments, we do believe that instruments that included these early call special events and qualified as regulatory capital when issued should be modified to only have prospective application for purposes of the Proposed Rules. Therefore, we request that the Agencies include within Section 20 language confirming that instruments that were outstanding on May 19, 2010 and included an early call right upon the occurrence of an event relating to a change in status under the 1940 Act or under rating agency criteria are not disqualified from inclusion in Additional Tier 1 capital or Tier 2 capital under Section 20 because of those provisions.

## D. Capital Buffers

1. The Agencies should, in practice, use their discretion in a reasonable, timely and judicious manner to permit distributions otherwise prohibited by the operation of the Capital Conservation Buffer in order to prevent the creation of another *de facto* minimum capital requirement in contradiction to the express intent of Basel III.

As noted above, we strongly support robust capital requirements and recognize that the introduction of the Capital Conservation Buffer is an important element thereof. We also agree with the BIS that the Capital Conservation Buffer should not "impose constraints for entering the [buffer] that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement."[88]

By definition, the Capital Conservation Buffer comes into play only to the extent the institution's capital is above mandated regulatory minimums.[89] Like any rule that is simultaneously over-inclusive and under-inclusive, the varying prescribed restrictions on capital distributions and certain executive compensation may be appropriate for a bank in some circumstances and not appropriate for the same institution in other circumstances. Similarly, these restrictions can be appropriate for some banks but not for others given the varying risk profiles across organizations. The calibration of the restrictions embodied in Section 11 of the Proposed Rules is, as proposed, untested by empirical evidence and experience over time in the capital markets. Thus, we are concerned that the prescriptive nature of these limitations when applied in an automatic manner could very well have the effect of creating *de facto* new regulatory minimum capital requirements unless the Agencies do, in practice, use their authority in Section 11(a)(4)(iv) of the Proposed Rules to permit capital distributions otherwise prohibited by the operation of the Capital Conservation Buffer in a reasonable, timely and judicious manner.

As the Basel III rules are implemented and the Agencies and capital markets participants gain empirical experience and perspective with respect to the operation of the Capital Conservation Buffer, we believe there will be circumstances where permitting banks to make capital distributions otherwise prohibited by the mechanical application of the Capital Conservation Buffer rules will be consistent with safe and sound operations and prudent supervisory risk management. Such circumstances may include, for example, where nonrecurring items unduly affect eligible net income (as defined in the Proposed Rules) or other specific circumstances have a negative temporary effect on regulatory capital ratios. By showing reasonable and appropriate flexibility in practice in connection with the Capital Conservation Buffer, we believe that the Agencies can avoid the creation of market perceptions of the buffer being an additional *de facto* capital floor contrary to the express intent of Basel III.

In furtherance of this objective, we respectfully urge the Agencies to include in the Proposed Rules a formal mechanism whereby banks could make capital distributions, subject to receipt of non-objection by the relevant Agency, even if they would otherwise be prohibited from making such distribution by the mechanical application of Section 11 of the Proposed Rule. As part of such mechanism, the Agencies should be required to respond to such approval

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[88] Basel III, ¶ 130.

[89] *See* Proposed Rules, § 11(a)(3).

requests in an expeditious manner – *e.g.*, ten business days – in light of the various timing considerations connected with the declaration of quarterly dividends, related record dates and investor expectations. We believe this would be consistent with the similar mechanism found in the Federal Reserve's Capital Plan Rules, for example.[90]

2. <u>The definition of "eligible retained income" for purposes of Section 11 of the Basel III NPR should be revised to eliminate the double counting of items already deducted from regulatory capital such as goodwill and other intangibles that flow through net income under U.S. GAAP.[91]</u>

Under Section 11(a) of the Proposed Rules, a bank faces graduated restrictions on its ability to make capital distributions if capital falls below the required 2.5% CET1 buffer. These restrictions are based on the "maximum payout amount" which is defined as "eligible retained income" times the maximum payout ratio based on the actual size of the Capital Conservation Buffer.[92] "Eligible retained income," in turn, is defined as the bank's "net income for the four calendar quarters preceding the current quarter, based on [BANK]'s most recent [REGULATORY REPORT], net of any capital distributions and associated tax effects not already reflected in net income."[93] With respect to a bank holding company, for example, "net income" is listed as Item 14 of Schedule HI of Form FR Y-9C and is adjusted for goodwill impairment losses and amortization expenses for other intangible losses.[94] This is consistent with U.S. GAAP as such items flow through the income statement.[95] However, goodwill and other intangible assets are already deducted from CET1 under Sections 22(a)(1) and (2) of the Proposed Rules. As such, the Capital Conservation Buffer maximum payout amount calculations appear to unnecessarily penalize banks for reductions in goodwill and amortization expenses for other intangible losses even though these items are already deducted for the purposes of regulatory capital calculations to begin with. We do not believe this double counting is warranted from a policy perspective and we respectfully urge the Agencies to modify the definition of "eligible retained income" to exclude such items which relate to elements already otherwise deducted from regulatory capital.

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[90] *See, e.g.*, 12 C.F.R. § 225.8(f).

[91] This Part II.D.2 is responsive to Question 8 in the Basel III NPR.

[92] Proposed Rules, § 11(a)(2)(ii)-(iii).

[93] Proposed Rules, § 11(a)(2)(i).

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

[95] *See* Form FR Y-9C, General Instruction A.

Similarly, because the definition of a "capital distribution" includes repurchases or redemptions (prior to maturity) of Tier 1 or Tier 2 capital elements, but does not give credit for "offsetting" issuances, the rule will unnecessarily penalize banks that redeem capital but contemporaneously replace such capital with an equal or greater amount of capital of an equivalent or higher quality. For example, the proposed definition would discourage banks from replacing high cost capital elements—or even capital elements, such as trust preferred securities, that no longer fully qualify as capital—with lower cost capital or fully eligible capital elements of an equivalent or higher quality. We again do not believe that this result is warranted or desired. Accordingly, we respectfully request that, for purposes of the definition of "eligible retained income," a "capital distribution" be defined so as to exclude any repurchase or redemption to the extent the capital repurchased or redeemed was replaced in a contemporaneous transaction by the issuance of capital of an equal or higher quality tier.

3. The Agencies should approach activation of the Countercyclical Capital Buffer with a great degree of caution and circumspection given the various analytical and practical challenges and potential flaws in its design and implementation.[96]

The underlying intent of the Countercyclical Capital Buffer of "taking into account the macro-financial environment in which banks function and to protect the banking system from systemic vulnerabilities that may build-up during periods of excessive credit growth" may indeed have some *prima facia* theoretical appeal. We are concerned, however, that the Countercyclical Capital Buffer construct as set forth in the Basel III capital framework[97] and Section 11(b) of the Proposed Rules contains significant analytical and policy-related challenges. More specifically:

- Although ostensibly intended to strengthen banks in the face of excessive credit growth, the Countercyclical Capital Buffer appears to operate as a macro economic tool in the guise of a bank regulatory requirement. It is unclear, however, as to exactly how the buffer will fit into the Federal Reserve's broader statutory monetary policy obligations,[98] including through the Open Market Committee. The Federal Reserve's monetary policy levers are time-tested and well-understood tools for dealing with macro economic risks and, as a policy

[96] This Part II.D.3 is responsive to Questions 10 and 12 in the Basel III NPR.

[97] *See* Proposed Rules, § 11(b).

[98] *See*, *e.g.*, Federal Reserve Act, § 2A.

matter, should be used before heading down the novel path of imposing new bank regulatory capital requirements.

- Given the relative lack of concentration in the U.S. banking market and that the Countercyclical Capital Buffer would only be applicable to a small number of banks subject to the Advanced Approaches NPR, it is uncertain that the buffer would actually have the desired macro economic effect. For example, to the extent that there is excess credit growth, the primary source of such growth may very well turn out to be the shadow banking system or other institutions that would not be subject to the proposed Countercyclical Capital Buffer.

- The Countercyclical Capital Buffer may also prove to be too blunt an instrument in practice as compared to other available tools, such as increasing the risk weight of particular asset classes and/or lines of business that appear to be over-heating in the broader macro economic environment, that may achieve a more targeted and therefore more effective result. For example, because any Countercyclical Capital Buffer would apply to a bank as a whole rather than any specific asset class, it could actually incentivize a bank to devote additional capital resources to those sectors that are experiencing the greatest growth, as such sectors may well be generating the most profits and, thus, best able to offset the additional costs resulting from imposition of the buffer.

In addition to these possible policy and analytical shortcomings, the implementation of the Countercyclical Capital Buffer in Section 11(b) of the Proposed Rules suffers from important practical flaws, uncertainties and ambiguities, including:

- The Basel III NPR leaves the methodology to be used by the Agencies for determining when to activate the Countercyclical Capital Buffer and at what magnitude quite unclear at best. Indeed, Section 11(b)(2)(iv) of the Proposed Rules describe the basis upon which the buffer could be activated in only the most vague, high level and generic terms – "a range of macroeconomic, financial, and supervisory information indicating an increase in systemic risk including, but not limited to, the ratio of credit to gross domestic product, a variety of asset prices, other factors indicative of relative credit and liquidity expansion or contraction, funding spreads, credit condition surveys, indices based on credit default swap spreads, options implied volatility, and measures of systemic risk." Thus, it will be very difficult if not impossible for banks to be able to plan for its possible activation.

- This uncertainty is further exacerbated by the international reciprocity provisions and the fact that each jurisdiction could make buffer decisions based on completely different macro economic or other indicators. This could inevitably lead to widely divergent treatment of a bank's capital requirements in its home country with respect to its operations in other countries based on little more than regulatory fiat by various national supervisors.

- Section 11(b)(3) of the Proposed Rules appears to require that the Agencies "*will* adjust"[99] the buffer for a subject U.S.-based bank dependent upon the decision of non-U.S. regulators to implement a countercyclical buffer in their own jurisdictions. The Basel III NPR appears to therefore provide little protection for U.S. banks in circumstances where the non-U.S. regulator's buffer decision is flawed, arbitrary or capricious.

- Although the Basel III NPR preamble indicates that the Agencies "anticipate" making joint decisions regarding the Countercyclical Capital Buffer, there appears to be no requirement that they actually do so. This could, in theory at least, lead to different buffers at the bank holding company versus the depository institution level.

- The 12-month period between announcement of the activation of the Countercyclical Capital Buffer and its effectiveness is completely within Agency discretion and could therefore be shortened, thus potentially leaving little time prior to effectiveness for banks to take appropriate action such as raising capital. In no event should banks have less than 12 months to prepare for the actual implementation of the buffer as a binding requirement.

Despite the concept's possible theoretical appeal, we believe that the cumulative impact of the foregoing problems counsels that the Agencies should approach the possible activation of the Countercyclical Capital Buffer with a great degree of caution and circumspection. If the Agencies do nevertheless determine to concretely pursue the possible activation of the Countercyclical Capital Buffer, we respectfully urge the Agencies to address the practical issues discussed above.

[99] Proposed Rules, § 11(b)(3) (emphasis added).

**E. The Agencies should not incorporate into their capital rules the Basel III leverage ratio until Basel III's parallel run period that continues until January 1, 2017 has lapsed and, in any event, should never subject a single bank to multiple leverage ratios.**

The Basel III NPR purports to address how the Agencies would implement for U.S. banks the leverage ratio set forth in Part V of Basel III (defined as the "**supplementary leverage ratio**" in the NPRs). Under Basel III, the supplementary leverage ratio would not become a Pillar 1 minimum requirement until January 1, 2018. Our concerns fall into three areas: (i) the timing of the Agencies' implementation of the supplementary leverage ratio; (ii) the proposal that Advanced Approaches banks ultimately be subject to two leverage ratios – the supplementary leverage ratio and the existing U.S. leverage ratio; and (iii) substantive concerns with the supplementary leverage ratio as defined in the Basel III NPR.

1. Timing Considerations.[100]

First, we strongly believe that the Agencies should not apply the supplementary leverage ratio to any U.S. banks earlier than the January 1, 2018 date provided for in Basel III. Section 10(a)(5) of the Proposed Rules, at least as set forth in the NPRs (likely mistakenly), would apply the supplementary leverage ratio to Advanced Approaches banks immediately upon effectiveness of the Proposed Rules in the Basel III NPR (targeted for January 1, 2013).[101] The amendments to the Agencies' prompt corrective action ("**PCA**") rules applicable to depository institutions, included within the Basel III NPR, contemplate that the supplementary leverage ratio would not become a component of the PCA regime until January 1, 2018. The supplementary leverage ratio should not become a binding constraint for any purpose until that date.

Second, and the core consideration in our view bearing on timing, we have serious concerns with aspects of the supplementary leverage ratio, both as proposed in the NPRs and in Basel III (and discussed in Part II.E.3). The BIS itself clearly has some uncertainty as to the contours of the supplementary leverage ratio, as reflected in its provision for a supervisory monitoring period through January 1, 2013 and parallel run period through January 1, 2017, to be followed by "any final adjustments to the definition and calibration of the leverage ratio [to

[100] This Part II.E.1 is responsive to Questions 13 and 38 of the Basel III NPR.

[101] As drafted, it appears that Section 10(a)(3) would apply the supplementary leverage ratio to an Advanced Approaches bank even before it exits its parallel run. We realize this is likely not the Agencies' intent. The Agencies recite, in the Basel III NPR preamble (at page 52,802), that the supplementary leverage ratio would become a binding requirement commencing January 1, 2018.

be] carried out in the first half of 2017," addressed in Part 5.C of Basel III. We strongly believe that the Agencies should not incorporate the supplementary leverage ratio in their capital rules until the parallel run period has terminated and international agreement is reached on final adjustments. In the meantime, in order to facilitate these supervisory monitoring and parallel run processes, we urge the Agencies to address the possibility of ultimately incorporating into their rules a Basel III-based supplementary leverage ratio by gathering confidential information through a reporting regime, perhaps eventually incorporated into the FR Y-14 series of reports that gather data for purposes of the Capital Plan Rule.

2. Single Leverage Ratio.[102]

As discussed in Part III.C (and raised by Question 2 in the preamble to the Basel III NPR), we are deeply concerned about the proliferation of capital ratios and the confusion that is likely to result among shareholders, other investors, market participants, and even non-bank regulatory authorities. In our view, a bank should never be subject to more than one leverage ratio at any point in time. It is possible that Congress will address the multiplicity of ratios seemingly required by the Collins Amendment before 2017, when the Agencies would need to adopt a Basel III-based leverage ratio if the U.S. rules are to follow international standards (under which the ratio would need to be a Pillar 1 standard by January 1, 2018, subject to the adjustments to the Basel III-based leverage ratio that may be made after the parallel run). In any event, we strongly believe that the end result should be a single leverage ratio applicable to all banks and that under no circumstances should Advanced Approaches banks (or any other banks for that matter) be required to comply with and report two leverage ratios.

3. Substantive Concerns.[103]

We have two overarching substantive concerns with the proposed leverage ratio. First, under the Proposed Rules, banks using the internal models methodology ("**IMM**") for calculating OTC derivative exposures for risk-weighted asset purposes are not permitted to use the IMM to calculate exposure for purposes of the supplementary leverage ratio. As a consequence, the exposure calculations in the risk-based capital ratio are inconsistent with the asset exposure calculation for the supplementary leverage ratio. More important, if the methods to calculate exposures are aligned, the outcomes would reflect the risk management activities of financial institutions. We urge the Agencies to revise paragraph (2) of the definition

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[102] This Part II.E.2 is responsive to Question 2 of the Basel III NPR.

[103] This Part II.E.3 is responsive to Questions 3 and 5 in the Basel III NPR.

of "total leverage exposure" to permit banks to calculate the potential future exposure amount for each derivative under Section 34 or Section 134 of the Proposed Rules.

Second, the inclusion of unfunded commitments (in addition to direct credit substitutes and recourse obligations) in the calculation of a bank's total leverage exposure runs counter to the leverage ratio's purpose as an on-balance sheet measure of capital that complements the risk-based capital ratios will constitute a duplicative assessment against banks (and, ultimately, their customers) when the liquidity coverage ratio is put into place[104] and, with a uniform 100% credit conversion factor, is not appropriately calibrated for the vastly different kinds of commitments that exist. At a minimum, the Agencies as well as international regulators acting through the BIS should approach components of the re-regulation of capital and liquidity consistently. Accordingly, if the supplementary leverage ratio is ultimately adopted and includes off-balance sheet items, the credit conversion factor should not be greater than the assumed draw-down ratios in the BIS liquidity framework's liquidity coverage ratio (*e.g.*, 5% for committed credit and liquidity facilities to retail and small business customers and 10% for committed credit facilities to non-financial corporates, sovereigns and central banks, public sector entities and multilateral development banks). We also note that the 10% conversion factor for unconditionally cancellable commitments, although consistent with Basel III, is not representative, in our view, of actual exposure. Banks have well-defined credit review processes and documentation requirements which prevent obligors from drawing-down on the facilities when their creditworthiness has substantially deteriorated. Indeed, both the current risk-based capital rules and section II.C of the preamble to the Standardized Approach NPR recognize this fact with a 0% conversion factor for such exposures. We note that the BIS is conducting further review on this subject and urge the agencies to lower the conversion factor for unconditionally cancellable commitments to be consistent with the Standardized Approach NPR.

Finally, we urge the Agencies to clarify the treatment under the proposed supplementary leverage ratio of collateral as a risk mitigant for OTC derivatives and securities financing transactions. While Basel III requires the use of the applicable accounting measure of exposure and Basel II's netting rules, it explicitly states that collateral may not be used to reduce the exposure. On the other hand, the EU's application of these provisions under

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[104] For example, if both the supplementary leverage ratio and the BIS' liquidity coverage ratio were adopted as proposed, for every \$100 in unfunded commitments a bank would be required to hold: (i) capital under the supplementary leverage ratio on the \$100 commitment; (ii) ≥100% of the \$100 commitment in unencumbered Level 1 or Level 2 assets to defease the commitment under the liquidity coverage ratio; and (iii) capital under the supplementary leverage ratio on the ≥\$100 of Level 1 or Level 2 assets, as applicable.

Proposed CRD IV[105] includes a special exemption to allow the use of collateral and margin to calculate, for purposes of the supplementary leverage ratio, the exposure value of repurchase transactions, securities or commodities lending or borrowing transactions, long settlement transactions and margin lending transactions. We believe that the same approach should be adopted by the Agencies for U.S. banks.

### F. The definition of "Advanced Approaches [BANK]" should be clarified not to include institutions that are still in the Advanced Approaches parallel run.

The definition of "Advanced Approaches [BANK]" in Section 2 refers to Section 100(b)(1) of subpart E of the Proposed Rules and therefore picks up any bank that meets the criteria therein – *i.e.*, $250 billion or more of total assets or $10 billion or more of on-balance sheet foreign exposure, regardless of whether such institution is still undergoing its Advanced Approaches parallel run required by Section 121(c) of the Proposed Rules. This is problematic and creates an inconsistency in the rules because, under Section 121(c), a bank must conduct a satisfactory parallel run in order to determine its risk-weighted assets under the Advanced Approaches, while, for example, Section 10(c) requires an Advanced Approaches bank to calculate its minimum capital ratios as the lower of the ratio of applicable capital to Standardized Approach risk-weighted assets and Advanced Approaches risk weighted assets, which Section 2 defines in terms of the sum of the elements required by Subpart E of the Proposed Rules. Thus, the definition of "Advanced Approaches [BANK]" in Section 2 of the Proposed Rules should be appropriately modified to exclude banks that meet the criteria for Section 100(b)(1) but have not yet exited their parallel run.

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[105] "**Proposed CRD IV**" as used in this letter refers to the proposed capital regulation issued on May 21, 2012 by the Council of the European Union titled *Proposal for a Regulation of the European Parliament and of the Council on Prudential Requirements for Credit Institutions and Investment Firms – Council General Approach*, EF 120 ECOFIN 418 CODEC 1349.

## III. Concerns Cutting Across the NPRs

### A. The securitization framework should be modified in certain respects in order to address misaligned incentives and opportunities for regulatory arbitrage.

1. The amount of risk-based capital required to be held against securitization exposures subject to the 1,250% risk weight should be capped at the amount of those exposures (a dollar-for-dollar cap).

Under the Proposed Rules, a 1,250% risk weight would be assigned to a number of securitization exposures that are deducted under existing capital rules or that are subject to revised frameworks created by the Agencies in response to Basel III or Section 939A of Dodd-Frank. The Agencies note that this shift to a 1,250% risk weight is being implemented in order to reduce differences in the measure of capital for purposes of the risk-based capital requirements as compared to the leverage capital requirements.[106] We fully endorse that objective.

The Agencies recognize as well, however, that this proposal would impose a penalty on banks with higher risk-based capital ratios and more robust capital positions. As observed in the Advanced Approaches NPR, "[t]he more a risk-based capital ratio exceeds 8.0%, the harsher is the effect of a 1,250% risk weight on risk-based capital ratios. Conversely, the effect of a 1,250% risk weight would be less harsh than a deduction from total capital for any risk-based capital ratio that is below 8.0%."[107] Such an outcome (as well as its related incentives and disincentives), runs counter to other aspects of the Proposed Rules and other financial-reform initiatives that are driving banks to increase and maintain sizeable cushions of loss-absorbing capital well in excess of 8%.

We believe that the aim of reducing disparities in the measure of capital for leverage and risk-based capital purposes can be achieved without creating a meaningful disincentive for banks to maintain robust capital positions well above regulatory minimums. The solution that we propose is a simple and straightforward one – that is, a cap on the amount of risk-based capital that a bank must hold for any securitization exposure fixed at the amount of that

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[106] Advanced Approaches NPR, 77 Fed. Reg. at 52,993.

[107] *Id.*

exposure (a dollar-for-dollar cap).[108] Specifically, the Proposed Rules would be revised as follows:

> § __.42(b): A [BANK]'s total risk-weighted assets for securitization exposures equals the sum of the risk-weighted asset amount for securitization exposures that the [BANK] risk weights under §§ __.41(c), __.42(a)(1), and __.43, __.44, or __.45, except as provided in §§ __.42(e) through (j). <u>Notwithstanding any other provision of Part [___], including §§ __.41 through __.45 of this Subpart D, the amount of risk-based capital that a [BANK] must hold for any securitization exposure or resecuritization exposure may not exceed and will be limited to the amount of the exposure.</u>

> § __.142(b): A [BANK]'s total risk-weighted assets for securitization exposures is equal to the sum of its risk-weighted assets calculated using §§ __.142 through __.146. <u>Notwithstanding any other provision of Part [___], including §§ __.141 through __.145 of this Subpart E, the amount of risk-based capital that a [BANK] must hold for any securitization exposure or resecuritization exposure may not exceed and will be limited to the amount of the exposure.</u>

> § __.210(b)(1): The total specific risk add-on for a portfolio of debt or securitization positions is the sum of the specific risk add-ons for individual debt or securitization positions, as computed under this section. To determine the specific risk add-on for individual debt or securitization positions, a [BANK] must multiply the absolute value of the current market value of each net long or net short debt or securitization position in the portfolio by the appropriate specific risk-weighting factor as set forth in paragraphs (b)(2)(i) through (b)(2)(vii) of this section. <u>Notwithstanding any other provision of Part [___], including §§ __.210 through __.211 of this Subpart F, the amount of risk-based capital that a [BANK] must hold for any securitization exposure or resecuritization exposure may not exceed and will be limited to the amount of the exposure.</u>

[108] We note that European authorities are also proposing to ensure that the amount of risk-based capital held for any securitization exposure does not exceed the amount of that exposure, albeit at present through the less ideal alternative of an optional deduction. *See* Proposed CRD IV, Article 33(1)(k).

2. The risk-based capital charge for any omission or other failure in fulfilling the yet-untested due diligence requirements should be based on the circumstances instead of being immediate, automatic, irreversible and highly punitive.[109]

Under Section 41(c) of the Proposed Rules, a bank must be able to demonstrate to the satisfaction of its primary federal supervisor a comprehensive understanding of the features of a securitization exposure that would materially affect performance. The bank's analysis must be commensurate with the complexity of the securitization exposure and the materiality of the exposure in relation to capital. To varying though unspecified degrees, depending on the exposure's complexity and materiality, the bank must consider structural features of the securitization that would materially impact the performance of the exposure, relevant information about the performance of the underlying credit exposures, relevant market data for the securitization,[110] and for resecuritization exposures performance information on the underlying securitization exposures.

It is understandable, in our view, that these due diligence requirements have been prescribed in broad brush strokes, for a wealth of diversity exists among asset classes, structures, issuers, and servicers in the securitization market and one size certainly would not fit all. It is equally understandable, however, that this principles-based approach to due diligence requires judgment and has already given and will continue to give rise to a number of interpretive and operational issues – just to scratch the surface: What would be relevant market data for exposures that are being acquired at issuance? Because no exposure standing alone will be material to a bank's capital, how should that standard be judged? In what kind of detail should analyses be documented?

In light of these implementation issues, we are deeply concerned about the non-discretionary and highly punitive 1,250% risk weight – even capped, as we have proposed above, at a dollar-for-dollar capital charge – that would be immediately imposed for any omission or other failure in satisfying the yet-untested due diligence requirements. Any principles-based approach, we believe, must be paired with a more flexible remedial scheme,

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[109] This Part III.A.2 is responsive to Question 17 of the Standardized Approach NPR and Question 13 of the Advanced Approaches NPR.

[110] We note that the guidance the OCC recently issued to clarify what due diligence should be performed, for example, to verify that investments meet newly established credit quality standards does not expressly include market-data requirements. *See* OCC, *Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment*, 77 Fed. Reg. 35,259 (June 13, 2012).

for the sake of not just the banks compelled to abide by it but also the regulatory authorities tasked with enforcing it.

We are equally concerned that this 1,250% risk weight appears to be irreversible regardless of any corrective action the bank subsequently takes to resolve any asserted due diligence shortcomings. This is particularly problematic in the context of due diligence issues that may arise inadvertently and without any negligence, that may be easily remedied or that may arise simply from a lack of timely available information.

We therefore recommend that the Agencies instead adopt the remedial approach incorporated into Article 122a of the European Union's Capital Requirements Directive ("**CRD II**").[111] There, if an infringement is found, regulatory authorities are directed to progressively increase the risk weight assigned to the related exposure depending on the severity and duration of the infringement.[112] In addition, although a formula for doing so is supplied as part of CRD II, authorities are cautioned not to be rigid or undifferentiated in its application.[113] The materiality and risk context of any breach, for example, must be taken into account by the relevant authority, as must circumstances beyond the control of the bank and subsequent steps taken by the bank to address any deficiencies.[114]

Adopting a remedial scheme like that in CRD II not only would better align the risk weight with the infringement, which is all the more appropriate in light of the subjectivity and judgment that are inherent in the due diligence requirements, but also would serve the aim of the Agencies to create a level international playing field wherever possible.

3. <u>The definition of resecuritization should be clarified in one instance and revised in another in order to avoid incentives and outcomes that do not further the policy objectives of the Proposed Rules.</u>

We acknowledge that the risks presented by opaque and extraordinarily complex resecuritization exposures were made apparent during the recent financial crisis, and we appreciate the need to treat these exposures more stringently under the Proposed Rules.

[111] *See also* Proposed CRD IV, Articles 395 and 396.

[112] Committee of European Banking Supervisors, *Guidelines to Article 122a of the Capital Requirements Directive*, ¶ 105 (Dec. 31, 2010).

[113] *Id.*

[114] *Id.*, ¶¶ 109 - 111.

Not all resecuritization exposures, however, are opaque or extraordinarily complex; to the contrary, some are just as clear and straightforward as plain-vanilla wholesale exposures. Yet, we recognize that lines can be difficult to draw in this context, and although a more risk-sensitive approach would have created better market incentives in our view, we respect the judgment of the Agencies to impose a conservative one-size-fits-all standard.

Nevertheless, we believe that one clarification and one revision to the resecuritization framework are crucial in order to avoid incentives and outcomes that do not further the policy objectives of the Proposed Rules.

First, we believe that the Agencies should clarify that a resecuritization involves more than one underlying exposure. The definition of resecuritization suggests such a condition by referencing "underlying exposures" in the plural, and we believe that this must be the case. Resecuritizing a single securitization exposure – which occurs, for example, in a Re-REMIC – is substantively no different than adding credit enhancement to that exposure. It would be incongruous to apply the supervisory calibration parameter of 1.5 to a credit-enhanced senior resecuritization exposure and, as a result, to treat that exposure as more risky than the underlying securitization exposure itself (which, of course, is the one with more risk). Therefore, we propose that the definition of resecuritization be revised as follows: "Resecuritization means a securitization with more than one underlying exposure in which one or more of the underlying exposures is a securitization exposure."

Second, we note that collateralized loan securitizations ("**CLOs**") historically have included a small percentage of other CLO exposures. The inclusion of these underlying CLO exposures has been designed to protect banks and other investors by enhancing diversification and liquidity within the CLO. We are not aware of this small basket of underlying CLO exposures ever having been cited negatively in the performance review of any CLO, which is not at all surprising in light of their insignificant magnitude, their investor-focused purpose, and their risk being reflective of the rest of the underlying corporate-loan exposures. For these reasons, and because existing securitizations cannot readily be amended to remove their underlying CLO exposures, we propose that the definition of resecuritization be further revised as follows: "Resecuritization means a securitization with more than one underlying exposure in which one or more of the underlying exposures is a securitization exposure, except that a corporate-exposure securitization in existence on [the effective date of the Final Rules] is not a resecuritization solely because 5% or less of the underlying exposures are corporate-exposure securitization exposures."

4. <u>The amount of any off-balance sheet securitization exposure should be capped at the maximum potential amount that the bank could be required to fund given the securitization SPE's underlying assets (calculated without regard to the current credit quality of those assets).</u>

In previous communications with the Agencies, we have identified a prevalent form of lending transaction that does not appear to have been considered when the Basel III regulatory capital and liquidity frameworks were developed.[115] This kind of lending transaction arises when a bank has concluded that principles of safety and soundness and prudent risk management counsel in favor of extending credit or liquidity to a bankruptcy-remote special purpose vehicle sponsored by a customer rather than directly to the customer itself. Commonly in such a bank-customer securitization, just like in more traditional lending transactions, the bank provides a commitment to the customer (here, more specifically, to its special purpose vehicle) that is not unconditionally cancelable but that is limited to the amount of eligible assets legally isolated by the customer in its special purpose vehicle (the "**available borrowing base**"). The Proposed Rules appear to treat this commitment as an off-balance sheet securitization exposure.

Prior to 2010, commitments in bank-customer securitizations were nearly always supplied by ABCP conduits that were not consolidated by the bank under U.S. GAAP or that were otherwise excluded from the bank's risk-weighted assets under rules adopted by the Agencies in 2003 and 2004.[116] As a result, while the bank's liquidity facilities and other commitments to its ABCP conduit could represent off-balance sheet securitization exposures for regulatory capital purposes, the ABCP conduit's commitments to customer-sponsored special purpose vehicles were not treated as exposures of the bank at all. In addition, because the total exposure of any bank to its ABCP conduit was effectively capped by the borrowing bases made available by the customer-sponsored special purpose vehicles, the Agencies made clear that the notional amount of an off-balance sheet securitization exposure to an ABCP conduit could be reduced to the maximum potential amount that the bank could be required to

[115] *See, e.g.*, ASF DFA Section 165 Comment Letter.

[116] *Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Consolidation of Asset-Backed Commercial Paper Programs and Other Related Issues*, 69 Fed. Reg. 44,908 (July 28, 2004); *Risk-Based Capital Guidelines*; *Capital Adequacy Guidelines*; *Capital Maintenance: Interim Capital Treatment of Consolidated Asset-Backed Commercial Paper Program Assets*; *Extension*, 69 Fed. Reg. 22,382 (Apr. 26, 2004); *Risk-Based Capital Guidelines*; *Capital Adequacy Guidelines*; *Capital Maintenance: Interim Capital Treatment of Consolidated Asset-Backed Commercial Paper Program Assets*, 68 Fed. Reg. 56,530 (Oct. 1, 2003).

fund given the ABCP program's underlying assets (calculated without regard to the current credit quality of those assets).[117]

All of this changed in 2009 and 2010 when the FASB adopted Statements of Financial Accounting Standards Nos. 166 and 167 and abandoned its financial-components approach to securitization accounting and when the Agencies followed suit by eliminating the exclusion of consolidated ABCP conduits from risk-weighted assets.[118] Since then, commitments to customer-sponsored special purpose vehicles have generally been extended by a bank's on-balance sheet conduit or directly by the bank itself and, in either case, have become off-balance sheet securitization exposures of the bank for regulatory capital purposes.

What has not changed, however, is the cap on each of these commitments that results from the customer-sponsored special purpose vehicle's available borrowing base. Sections 42(c)(2) and 142(e)(2) of the Proposed Rules, however, continue to refer only to off-balance-sheet securitization exposures to ABCP conduits and not to other off-balance sheet exposures. We therefore propose that each of these subsections be revised as follows:

> The amount of an off-balance sheet securitization exposure that is not an OTC derivative contract (other than a credit derivative) is the lesser of (i) the notional amount of the exposure~~. For an off-balance-sheet securitization exposure to an ABCP program, such as a liquidity facility, the notional amount may be reduced to~~ and (ii) the maximum potential amount that the [bank] could be required to fund given the ~~ABCP program's~~ securitization SPE's current underlying assets (calculated without regard to the current credit quality of those assets).

5. The apparent technical glitch in Section 144(b)(1) of the Proposed Rules should be fixed to properly refer to the Standardized Approach.

Section 144(b)(1) of the Proposed Rules provides that, when applying the Simplified Supervisory Formula Approach ("**SSFA**") under the Advanced Approaches (Subpart E), "$K_G$ 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*."[119] Based on the

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[117] *See Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II*, 72 Fed. Reg. 69,288 (Dec. 7, 2007).

[118] *Risk-Based Capital Guidelines*; *Capital Adequacy Guidelines*; *Capital Maintenance: Regulatory Capital*; *Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues*, Fed. Reg. 4.636 (Jan. 28, 2010).

[119] Proposed Rules, § 144(b)(1) (emphasis added).

associated commentary and consistent with Sections 43(b)(1) and 211(b)(1) of the Proposed Rules, we believe that this reference should instead be to "subpart D" – *i.e.*, to the total capital requirement of the underlying exposures using the Standardized Approach.

6. Student-status deferments should not be considered contractually deferred interest payments in the computation of parameter W under the SSFA.

Unlike most consumer-loan products, both private and federal student loans are structured to defer a borrower's payments during specified periods based on the borrower's student status. For example, many student loans (i) do not require payment while the borrower is enrolled in school, (ii) provide a grace period after graduation before payments are required to begin, and (iii) provide for deferment of payment obligations upon the borrower's return to school to complete a degree or conduct post-graduate study.

As recently communicated to the Agencies, we are concerned that these student-status deferments could be considered contractually deferred interest payments and, therefore, cause securitized student-loan exposures to be included in the computation of parameter W under the SSFA.[120]

We do not believe that the Agencies intended such a result, especially in the context of Federal Family Education Loan Program ("**FFELP**") student loans. Because the federal government guarantees 97% to 100% of the principal and accrued interest of FFELP student loans, a bank's risk of loss in connection with payment deferrals of this nature would never be more than 3%.

As a result, we continue to request that the Agencies clarify that private or federal student loans are not included in parameter W as having contractually deferred interest payments if the deferment is due to the borrower's student status (that is, (i) in school, (ii) in a grace period after graduation, or (iii) in deferment or forbearance).

[120] Letter from ASF to the Agencies, dated August 22, 2012, addressing student-status deferments under the SSFA.

7. The definition of "financial collateral" should continue to include conforming residential mortgage exposures and some non-investment-grade securitization exposures.[121]

Under existing regulatory capital rules, financial collateral includes, in part, (i) long-term debt securities that have an applicable external rating of one category below investment grade or higher, (ii) short-term debt instruments that have an applicable external rating of at least investment grade, and (iii) conforming residential mortgages.

Because of the mandate to remove any reference to or requirement of reliance on credit ratings under Section 939A of Dodd-Frank, the Agencies have proposed in the NPRs to substitute in place of the first two provisions (i) long-term debt securities that are not resecuritization exposures and that are investment grade and (ii) short-term debt instruments that are not resecuritization exposures and that are investment grade. The Agencies also have proposed to eliminate conforming residential mortgage exposures from the definition of financial collateral.

The exclusion of conforming residential mortgage exposures appears to be based upon the Agencies' conclusion that there is insufficient liquidity in this market. We believe that this conclusion is incorrect because these transactions provide liquidity and funding to the housing market. The changes proposed would cause banks to increase the amount of capital they are required to hold against these transactions, and the likely impact of raising capital would be to increase interest rates on these transactions, reduce liquidity in the market and harm the housing market. The change would also likely require banks to restructure the transactions in a way that loses important protections, including protections against the automatic stay.

We are concerned as well about non-investment-grade securitization exposures being treated as ineligible financial collateral for repo/reverse repo purposes. Vast amounts of originally rated "AAA" senior, thick-tranched Non-Agency RMBS bonds have been downgraded by rating agencies and may be deemed ineligible for repo/reverse-repo purposes. We would welcome the opportunity to discuss with the Agencies an approach that would utilize the creditworthiness of the underlying security as and input to determine the suitability of a securitization exposure as eligible financial collateral. We also would welcome the opportunity to discuss with the Agencies a methodology for determining if a securitization exposure is investment grade.

[121] This Part III.A.7 is responsive to Question 1 of the Advanced Approaches NPR.

**B. We urge the Agencies to revise the NPRs' treatment of exposures to central counterparties to include the interim framework released by the BIS in July 2012 and, going forward, to work expeditiously with other national regulators to address other concerns with the BIS' and the Agencies' approach.**[122]

The Agencies approved the NPRs in June 2012 before the BIS released its revised interim framework (the "**BIS Interim CCP Framework**") for determining capital requirements for banks' exposures to central counterparties ("**CCPs**").[123] The Advanced Approaches NPR and Standardized Approach NPR address exposures to CCPs largely by implementing the BIS' November 2011 proposals on which comments were due by November 25, 2011 (the "**BIS CCP Proposals**).[124] The BIS Interim CCP Framework, in turn, follows the BIS CCP Proposals with limited changes – the three most important being:

- the introduction of a simplified method (referred to as "**Method 2**" in the BIS Interim CCP Framework) for addressing default fund exposures, calculated for a clearing member by applying a 1,250% risk weight to its default fund exposure to a CCP, with an overall cap on its risk-weighted assets from all of its exposures to the CCP equal to 20% of its trade exposures on an IMM basis to the CCP;

- for purposes of the base case method of calculating default fund exposures (referred to now as "**Method 1**" in the BIS Interim CCP Framework), retaining the requirement that a CCP's hypothetical calculation of its own capital be based on the current exposure method ("**CEM**") but increasing the weighting of the netted portion of the calculation from 60% to 85%; and

- recognizing a shorter close-out period for cleared transactions and allowing cleared members to apply a margin period of risk of at least five days (in the case of Advanced Approaches banks adopting the IMM) or multiply the exposure at default by a scalar of no less than 0.71 (in the case of clearing members, whether or not Advanced Approaches banks) using the CEM – although clearing members' exposures to clients are still categorized as bilateral trades for regulatory capital purposes.

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[122] This Part III.B is responsive to Questions 13 and 15 of the Standardized Approach NPR, and Question 6 of the Advanced Approaches NPR.

[123] BIS, *Capital Requirements for Bank Exposures to Central Counterparties* (July 2012).

[124] BIS, *Consultative Document – Capitalization of Bank Exposures to Central Counterparties* (Nov. 2011).

We support the Agencies' and international regulators' objective of creating incentives for banks to increase their use of CCPs. Under Title VII of Dodd-Frank swap dealers, security-based swap dealers, major swap participants and major security-based swap participants must generally execute their transactions on a centralized exchange or regulated facility and must clear their transactions through a regulated CCP (called a "derivatives clearing organization", or "**DCO**", in Dodd-Frank and related rules proposed by the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**")). Moreover, we appreciate the need to address the potential for risk concentration and systemic risk increases arising from the increased use of CCPs, as noted by the Agencies in the preambles to the Advanced Approaches NPR and the Standardized Approach NPR. However, as is apparent from the BIS' release of the BIS Interim CCP Framework, and its changes as compared to the BIS CCP proposals (even if modest), there is still a great deal of work to be done in order to develop a comprehensive framework for addressing CCPs.

We urge the Agencies to incorporate into the Proposed Rules the BIS Interim CCP Framework's improvements to the BIS CCP proposals – namely, Method 2 for addressing the exposure to default fund contributions, the increased recognition of netting for purposes of the hypothetical CCP capital calculation used in Method 1, and the shorter close-out period for cleared transactions.

Equally important, however, we urge the Agencies and international regulators to address expeditiously our fundamental concern with the incomplete capital framework for CCPs – namely, the required use of CEM (i) for purposes of calculating the exposure amount of clearing members' and clearing member clients' cleared transactions under the Standardized Approach (including for U.S. banks in the Standardized Approach NPR) and (ii) in Method 1 as the basis for calculating a CCP's own hypothetical capital requirements. The CEM is a blunt, risk-insensitive approach that does not accurately measure exposures and requires reform. The Clearing House and others commented on this necessary reform at length in the context of the Federal Reserve's proposed rules under Dodd-Frank Section 165(e) (regarding the use of CEM for measuring the single counterparty credit limits addressed in those rules).[125]

Finally, the definition of "qualifying central counterparty" ("**QCCP**") for purposes of the NPRs encompasses a variety of criteria, including the relevant bank having demonstrated to the satisfaction of the applicable agency that the CCP is "in sound financial condition." Dodd-Frank includes extensive provisions addressing the regulation of CCPs, including the requirement that DCOs that make use of the mails or any means or instrumentality of interstate commerce in the

[125] *See* TCH DFA Section 165 Comment Letter, Annex C (commenting on aspects of the proposed rules regarding single-counterparty credit limits, including the use of the CEM in the proposed rules' calculation methodology).

United States be registered with the CFTC or SEC. CCPs registered with the CFTC or the SEC will be subject to extensive regulation designed to ensure the soundness of their financial condition, including: requirements that registered CCPs maintain adequate financial resources; utilize appropriate risk management mechanisms, including margining systems that satisfy specified criteria, monitoring and testing of exposures, imposition of concentration and other limits and similar measures; establish and enforce participant eligibility criteria; employ appropriate and sufficient settlement procedures; and adopt and enforce standards and procedures to segregate and protect client assets.[126] We urge the Agencies to provide in their final rules that any CCP that is registered with the CFTC or SEC is a QCCP, provided that it agrees to make available to its clearing members and their clearing member clients the information required by clause (4) of the QCCP definition that is necessary for capital calculations. As a practical matter, the only CCPs that will not be subject to extensive regulation and supervision by the CFTC or the SEC, and for whom the type of showing contemplated by clause (3) of the Proposed Rules' definition of QCCP is warranted, are CCPs organized outside the United States whose use of U.S. jurisdictional means is so limited as to entitle them to not be registered with the CFTC or SEC and, accordingly, not subject themselves to regulation and supervision by those agencies.

**C. U.S. banks – particularly Advanced Approaches banks – will be subject to a proliferation of capital ratios, creating market confusion as to inter-relationships among ratios and which ratio is the binding constraint for an individual bank, as well as entailing substantial expense.[127] It is critically important that the Agencies and other policy makers ultimately address this complex array of ratios by developing a more direct and rational approach, even if requiring legislative action.**

Prior to the Collins Amendment and Basel III, U.S. banks were required to calculate and manage to three regulatory capital ratios – Tier 1 capital to risk-weighted assets, total capital to risk-weighted assets and leverage. Advanced Approaches banks were subject to the additional requirement during their parallel run and transitional floor periods of calculating Tier 1 and total capital ratios under both the Advanced Approaches and general risk-based capital approach.

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[126] *See, e.g.*, CFTC, *Derivatives Clearing Organization General Provisions and Core Principles*, 76 Fed. Reg. 69,334 (Nov. 8, 2011).

[127] This Part III.C is responsive to Question 2 of the Basel III NPR.

Under the regime contemplated by the NPRs when fully effective, even Standardized Approach banks would be subject to one additional ratio – CET1 to risk-weighted assets – and Advanced Approaches banks would be subject to eight ratios on a permanent basis – three (CET1, Tier 1 and total capital to risk-weighted assets) under the Advanced Approaches and the Standardized Approach and two leverage ratios (the existing U.S. leverage ratio as well as the supplementary leverage ratio derived from Basel III). And as a practical matter for 2013 and 2014, if the Agencies proceed as proposed (either because regulators will require Advanced Approaches banks when they file capital plans under the Capital Plans Rule or the investor and analyst communities require it), Advanced Approaches banks will be evaluated against eleven capital ratios – the aforementioned eight ratios plus the ratios of CET1 *plus* Tier 1 and total capital to risk-weighted assets under the existing general risk-based capital rules. Indeed, this actually understates the multiplicity of ratios because it does not include the different levels within various regimes at which restrictions are imposed – for example, under the Agencies' PCA rules, the Capital Plan Rule, the stress testing requirements under Section 165(i) of Dodd-Frank and the proposed Federal Reserve regulations implementing those requirements (the "**Stress Test Rules**"),[128] and the separate calculations required of depository institution subsidiaries of bank holding companies, including under the Stress Test Rules.

The more than doubling of required ratios for Advanced Approaches banks is largely the result of the Collins Amendment floor. As indicated in the introductory paragraphs to this letter and addressed in prior comment letters, we realize that the Agencies have no choice but to implement the Collins Amendment floor. In the intermediate term and as discussed further in Part II.E above, we urge the Agencies to maintain a single leverage ratio for all banks (both Advanced Approaches and non-Advanced Approaches) – using the Agencies' existing leverage ratio until the January 1, 2018 date provided in Basel III and, commencing on January 1, 2018, the Basel III supplementary leverage ratio as modified before that date – in order to avoid the unnecessary and unwarranted duplication of required ratios. This proposal is discussed in additional detail in Part II.E.

More fundamentally, we think it essential that policymakers – both the Agencies and Congress – work toward a solution that retains robust capital requirements but avoids the extraordinary duplication to which Advanced Approaches banks will be subject[129]. The proliferation of capital ratios is nonsensical and eventually must be addressed. The multiplicity

[128] *See* 77 Fed. Reg. 594 (Jan. 5, 2012).

[129] As discussed in Part II.F, *infra*, we believe the term "Advanced Approaches [BANK]" as used in the proposal was meant to refer to banks that have completed their parallel run under the Advanced Approaches (and thus are required to publicly report their capital ratios using their risk-weighted assets calculated under the Advanced Approaches).

of ratios does real harm – both because of the extraordinary cost of compliance and, of even greater importance, the confusion it engenders for managements, boards of directors and investors — contributing, we believe, to depressed prices for banks' common stock. Stated bluntly, if the market cannot tell which out of a multiplicity of ratios is the "right" one, a natural tendency will be to treat them all as lacking credibility.

We very much appreciate and strongly support the Agencies' recognition in the Basel III NPR that the capital buffers are not "requirements" within the meaning of the Collins Amendment and, accordingly, Advanced Approaches banks should use Advanced Approaches risk-weighted assets when calculating buffers (both the Capital Conservation Buffer and, if invoked, the Countercyclical Capital Buffer) and not calculate buffers twice, once using standardized risk-weighted assets and once using Advanced Approaches risk-weighted assets. To do otherwise would exacerbate the multiplicity of capital ratios and, in our view, would exceed the mandate of the Collins Amendment.[130]

**D. Banks should be able to recognize economically effective hedge pairs in accordance with policies and procedures that are subject to regulatory review and approval irrespective of whether the equity securities are publicly traded.**

The interplay between the Amended Market Risk Rules that will become effective on January 1, 2013[131] and the specific risk component of the treatment of equity exposures that hedge each other under the Proposed Rules in both the Standardized Approach NPR and the Advanced Approaches NPR will have the effect of substantially increasing the amount of capital that banks subject to the Amended Market Risk Rules will be required to maintain against certain equity exposures, notwithstanding that the exposures may create an effective economic hedge as to each other. Specific examples would include Rule 144A common stock, pink sheets, OTC Bulletin Board stock, hedge fund interests, certain unlisted mutual fund positions or other unregistered equity positions, and total return swaps written on such positions.

Under the existing market risk rules, banks are permitted to calculate the market risk charge for pairs of equities that hedge each other and that are covered positions for purposes of those rules based on the net-long or net-short position resulting from the pair, irrespective of whether either or both of the securities is traded on an exchange registered with the SEC as

[130] This provision is implemented through footnote 2 to Section 11(a)(3) of the Proposed Rules and is discussed in footnote 33 of the preamble to the Basel III NPR. The same approach should be applied to any other buffers or surcharges the Agencies may consider, including any G-SIB or D-SIB surcharge that may be applied to one or more Advanced Approaches banks.

[131] *See* 77 Fed. Reg. 53,060 (Aug. 30, 2012).

a national securities exchange. The Amended Market Risk Rules redefine the term "covered position" to exclude "any equity position that is not publicly traded, other than a derivative that references a publicly-traded equity."[132] The Amended Market Risk Rules as well as the NPRs generally define the term "publicly traded" to mean securities that are traded on a national securities exchange registered with the SEC (and certain qualifying foreign exchanges). As a consequence, pairs of equity securities where either or both of the securities are not traded on a qualifying public securities exchange, irrespective of whether the securities are freely transferable (and are not restricted securities within the meaning of Rule 144 under the Securities Act of 1933), will be subject to capital charges calculated under the banking book provisions in Section 52 (Standardized Approach) or 152 (Advanced Approaches) of the Proposed Rules, irrespective of whether the hedge itself is actually effective from an economic perspective. Both of those rules specify that:

> "A hedge pair is two equity exposures that form an effective hedge so long as each equity position is publicly-traded or has a return that is primarily based on a publicly-traded exposure."

We do not believe that only securities that are publicly traded within the meaning of the Proposed Rules form an effective hedge. In particular, we believe that there are various privately placed securities (including those distributed under Rule 144A), that although not "publicly traded", nevertheless can be part of an economically effective hedge pair. We therefore urge the Agencies to revise the Proposed Rule's hedge pair provisions to provide that equity securities which a bank has determined, in accordance with preexisting policies, procedures and methodologies which have been approved by its primary regulator, comprise an effective economic hedge even if not publicly traded.

## IV. Standardized Approach NPR[133]

Regulators and banks have recognized for many years that the general risk-based capital rules, largely unchanged from the 1988 Basel Accord insofar as risk weights of exposures in the denominator are concerned, are insufficiently risk sensitive.[134] Accordingly, we support the

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[132] Proposed Rules, § 2, Clause (3)(v) of the definition of "Covered Position."

[133] In addition to the comments in this Part IV, we have commented on the Standardized Approach NPR's securitization provisions in Part III.A and its CCP provisions in Part III.B.

[134] Although the Agencies did not adopt Basel II's standardized approach for non-Advanced Approaches banks when it implemented Basel II in the United States, they have twice sought comment on proposals to make the general risk-based capital rules more risk-sensitive – first, with a proposal referred to as "**Basel IA**" in 2006 (71 Fed. Reg. 77,446 (Dec. 26, 2006)), and in 2008 with a notice of proposed rulemaking largely based on the Basel II

(continued...)

Standardized Approach NPR's objective of applying more risk-sensitive risk weightings in the general risk-based capital rules. However, we strongly believe that the Standardized Approach NPR's provisions with respect to a number of risk exposures should be reconsidered by the Agencies and adjusted in the final rules.

**A. The Standardized Approach NPR's treatment of residential mortgage exposures should be revised to (i) recognize that not all junior lien exposures are higher risk and, accordingly, accommodate inclusion of non-"piggy-back" junior liens in category 1, (ii) treat low-risk interest only loans as category 1, (iii) recognize the difficulties (and in some cases impossibility) of applying the new regime to outstanding residential mortgage loans by continuing to apply the existing 50%/100% risk-weighting approach to those loans, and (iv) accommodate differences in lending standards in other countries by permitting banks to use the risk weightings of national regulators in OECD countries.**[135]

There is no question that a broad range of distortions in the residential mortgage market contributed significantly to the financial crisis and losses incurred by banks. Those distortions included the factors noted by the Agencies in the preamble to the Standardized Approach NPR[136] and were magnified by government policies that inflated perceived real estate values. Accordingly, our members support revisiting the general risk-based capital rules' current risk weightings of 50% for seasoned one-to-four family and multi-family residential mortgages meeting certain criteria and 100% for other residential mortgages. And we generally agree with the two key components of the Agencies' approach – (i) the recognition, implicit in the use of loan-to-value (the "**LTV**") ratios in Table 6, that LTVs are a primary predictor of future losses on residential mortgage loans and (ii) the recognition that certain types of mortgage loans have risk characteristics that warrant a higher risk weighting notwithstanding that they may have LTVs that are comparable to LTVs of other loans not having those characteristics. However, the Standardized Approach NPR's treatment of residential mortgages should be adjusted in certain limited but important respects, both to avoid unfairly penalizing certain types of residential mortgages and to recognize the impracticality of applying the new standards to outstanding mortgages and foreign exposures.

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(...continued)
standardized approach (73 Fed. Reg. 43,982 (July 9, 2008)), the comment period to which expired in October 2008 in the midst of the financial crisis.

[135] This Part IV.A is responsive to Questions 5, 6 and 7 of the Standardized Approach NPR.

[136] At 52,898.

First, although we generally agree with the distinction drawn between "category 1 residential mortgage exposure" and "category 2 residential mortgage exposure", there are four respects in which we believe the definition of category 1 residential mortgage exposure should be expanded, as follows:

- Clause (8) in the Agencies' proposed definition of category 1 residential mortgage exposure draws no distinction between various types of junior liens and, as written, would have the consequences of:

  - treating all junior-lien residential mortgage exposures as category 2;

  - treating a mortgage exposure that is otherwise category 1 as category 2 if the bank holds a junior-lien residential mortgage exposure that does not satisfy all of the category 1 criteria, even if there is no other party with an intervening lien; and

  - treating high-quality home equity lines of credit ("**HELOCs**"), most of which are junior liens, as category 2.

  We strongly believe that these consequences are inappropriate and inapposite, <u>except</u> where the junior lien exposure was originated simultaneously with a first lien (so-called "**piggy-back mortgages**"). A recent study by the Federal Reserve Bank of New York presented data suggesting that wholesale classification of various types of junior-lien mortgages as category 2 exposures is inappropriate.[137] This study shows that lenders provided junior-lien 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.[138] These HELOCs generally performed consistently with prime mortgage exposures.[139] By contrast, piggy-back mortgages often were originated to borrowers with low credit scores to lower the borrower's initial down payment.[140] These piggy-back,

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

[138] *Id.* at 3, 6-7, 1-12.

[139] *Id.*

[140] *Id.* at 6, 11-12.

closed-end mortgages generally performed in line with non-prime exposures.[141] Based on the risk characteristics presented in the FRBNY 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.

More generally, there is no reason why a qualifying first-lien residential exposure that is not accompanied by a piggy-back mortgage should be tainted by the fact that the bank makes junior-lien mortgage loans to the same borrower. Were the Agencies' proposed treatment retained, banks making first-lien loans as a practical matter would not be able to make junior-lien loans to the same borrowers, or *vice versa*.

Accordingly, we strongly urge the Agencies to revise the definition of category 1 residential mortgage exposures to permit inclusion in category 1 of non-piggy-back junior-lien residential mortgages loans otherwise meeting the category 1 LTV and other criteria, including both HELOCs and closed-end loans, and eliminate the provisions that would cause a junior-lien residential mortgage exposure to "taint" the category 1 eligibility of a first-lien residential mortgage loan made by the same bank.

- The Agencies' proposed language appears to treat as category 2 residential mortgages those residential mortgages that permit the borrower to pay only interest for a specified number of years (generally five or ten years), followed by an amortization period that amortizes the principal amount of the loan over a conventional period (generally 15 or 20 years). The language in the Agencies' proposed definition that may have this consequence is clause (2)(ii), which reads "(ii) [a]llow the borrower to defer repayment of principal of the residential mortgage exposure." We strongly urge the Agencies either to delete that language or to confirm that the language does not encompass loans that, without resulting in an increase in principal balance or resulting in a balloon payment, have a non-amortization period of up to ten years followed by an amortization period of not less than 15 years. Many banks, including our members, originate loans of this type. We believe that these loans typically have lower loss experience than other residential mortgage loans that satisfy the

[141] *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.

criteria for category 1 with comparable LTVs. These loans tend to be originated by banks' wealth management areas, with the banks' reliance upon the real estate collateral being less important because the loans are to borrowers with substantially greater resources. These loans are also typically repaid in full before the amortization period begins.

- Clause (2)(iii) in the Agencies' proposed definition of category 1 residential mortgage exposure would treat all mortgage loans having a balloon payment as category 2. Some lenders developed loan products that began with low "teaser" rates combined with balloon payments of principal in the relatively short term (in some cases as early as 2 years after origination) that had higher than average delinquency rates during the financial crisis. However, we do not believe that all mortgages with balloon payments warrant the higher risk weightings accorded to category 2 mortgages and suggest that the Agencies use as the dividing line between balloon payments that are consistent with category 1 treatment and those that pose higher risks that require the loans to be treated as category 2 loans where the balloon payment is at least ten years after origination. Younger borrowers buying a first home that they do not expect to live in for a substantial portion of their adult lives and who are focused on minimizing their monthly mortgage payments as well as high net worth borrowers who finance home purchases largely as part of their funds management plans both find these loans to be attractive, and our members' experience with these loans is that they are not higher risk. Most of these loans are refinanced well before the balloon payment becomes due. Accordingly, we suggest that balloon mortgages where the balloon payment comes due not earlier than ten years after origination of the mortgage be treated as category 1.

- The Agencies asked in the preamble to the Standardized Approach NPR (Question 5) whether all residential mortgages that meet the "qualified mortgage" criteria to be established for purposes of the TILA as amended by Section 1412 of Dodd-Frank should be included in category 1. We believe they should, irrespective of whether such a qualified mortgage meets the other criteria specified for a category 1 residential mortgage exposure. The concept of a "qualified mortgage" was added by Dodd-Frank to the TILA for the purpose of identifying lower risk loans that are deemed to satisfy the underwriting standards set forth in new Section 129C of the TILA that was added by Dodd-Frank. It makes little sense for the government to carefully define lower risk mortgages in one context and then not to include such mortgages in a capital rule category that is also designed to capture lower risk mortgages.

In order to address the foregoing, we recommend that the definition of category 1 residential mortgage exposure be revised to read as follows:

> Category 1 residential mortgage exposure means (A) a "qualified mortgage" as defined in Section 129C(b)(2) of the Truth in Lending Act, 15 U.S.C. § 1639c(b)(2), and regulations adopted thereunder or (B) a residential mortgage exposure with the following characteristics:
>
> (1) The original term of the mortgage exposure does not exceed 30 years;
>
> (2) The terms of the mortgage exposure provide for regular periodic payments that do not:
>
> (i) Result in an increase of the principal balance; or
>
> ~~(ii) Allow the borrower to defer repayment of principal of the residential mortgage exposure; or~~
>
> (ii~~i~~) Result in a balloon payment that becomes due earlier than ten years after the date of the closing of the residential mortgage exposure transaction;
>
> (3) The standards used to underwrite the residential mortgage exposure:
>
> (i) Took into account all of the borrower's obligations, including for mortgage obligations, principal, interest, taxes, insurance (including mortgage guarantee insurance) and assessments; and
>
> (ii) Resulted in a conclusion that the borrower is able to repay the exposure using:
>
> (A) The maximum interest rate that may apply during the first five years after the date of the closing of the residential mortgage exposure transaction; and
>
> (B) The amount of the residential mortgage exposure is the maximum possible contractual exposure over the life of the mortgage as of the date of the closing of the transaction;

(4) The terms of the residential mortgage exposure allow the annual rate of interest to increase no more than two percentage points in any 12-month period and no more than six percentage points over the life of the exposure;

(5) For a ~~first-lien~~ home equity line of credit (HELOC), irrespective of its lien priority, the borrower must be qualified using the principal and interest payments based on the maximum contractual exposure under the terms of the HELOC;

(6) The determination of the borrower's ability to repay is based on documented, verified income;

(7) The residential mortgage exposure is not 90 days or more past due or on non-accrual status; and

(8) The residential mortgage exposure is

(i) a ~~not a junior~~ first-lien residential mortgage exposure, ~~and~~ or

(ii) ~~if~~ (A) the residential ~~mortgage~~ exposure is a ~~first-~~junior-lien residential mortgage exposure ~~held by~~ ~~and~~; (B) if a single banking organization ~~and secured by first and junior lien(s) where~~ holds a first-lien residential mortgage exposure secured by the same real property, (x) such first-lien residential mortgage exposure has ~~having~~ the characteristics set forth in paragraphs (1) through (7) ~~and~~, (y) no other party holds an intervening lien~~,~~ and (z) such first lien and junior lien residential mortgage exposures were not originated by the banking organization at substantially the same time; and (C) ~~each~~ such junior-lien residential mortgage exposure has ~~must have~~ the characteristics ~~of a category 1 residential mortgage exposure as set forth in this definition~~ set forth in paragraphs (1) through (7); except as provided below for HELOCs.

Notwithstanding paragraphs (1) through (8):

(a) the [AGENCY] may determine that a residential mortgage exposure that is not prudently underwritten does not qualify as a category 1 residential mortgage exposure; and

(b) the criteria in paragraphs (2) and (4) shall not apply to HELOCs.

Second, we believe the Agencies should continue to apply the existing 50%/100% risk-weighting of mortgage loans that were or are originated on or before the date that is one year after final rules pursuant to the Standardized Approach NPR are published in the Federal Register. Such a continued application of the existing risk-weighting regime is appropriate for several reasons. Because the detailed criteria for category 1 loans were only just proposed (and will not be definitively known until the final rules are issued), the information systems of banks may not include the data necessary to determine whether an existing residential mortgage loan qualifies as a category 1 loan. These data limitations are likely to be particularly pronounced with respect to the proposed underwriting criteria and with respect to mortgages purchased from third parties or acquired as part of an acquisition. In addition, banks will need adequate time to ensure that their systems capture the necessary data for new loans. As a result, applying the proposed criteria to loans originated prior to the date one year after final rules are published in the Federal Register could result in a substantial number of loans that might qualify as category 1 loans unfairly being subject to the higher risk weights associated with category 2 loans solely because of data limitations.

Moreover, this is particularly important for residential mortgage exposures underlying securitizations that close prior to the date that is one year after the effective date of the final rules. Banks that hold exposures to securitizations already in existence have no ability to compel the sponsors, issuers or servicers to disclose how the underlying residential mortgage exposures would be characterized under the framework ultimately adopted by the Agencies and, as a result, would be precluded from applying the Supervisory Formula Approach or the SSFA to these securitization exposures. In addition, to the extent that sponsors, issuers and servicers in future securitizations are willing to dedicate systems and other operational resources to identifying and disclosing risk-based capital characterizations in order to maintain their banking-organization investor base, we are concerned that this will consume a sufficiently material amount of time so that a minimum one-year transition period is warranted.

While it is true that, in some cases, the missing information may be available in the underlying loan files, we believe that requiring banks to conduct a review of potentially millions of loan files for performing loans simply to avoid the retroactive application of the new proposed risk weights is unnecessary and unduly burdensome.

Third, we recommend that a new clause (5) be added to Section 32(g) reading as follows:

> (5) Non-U.S. Residential Mortgage Exposures.
> Notwithstanding (and as an alternative to) the risk weights for residential mortgage exposures provided for in Table 6, a [BANK] may assign to any residential mortgage exposures on real

property located in countries other than the United States that have adopted the Basel Committee on Banking Supervision's regulatory capital framework the risk weighting permitted under the general or standardized risk-based capital rules of the host country regulator in the jurisdiction where the real property is located.

The proposed definition of category 1 residential mortgage exposure is U.S.-centric in that it reflects U.S. practice, not the practice in Europe or other countries where U.S. banks with an international footprint have substantial residential mortgage portfolios or invest in non-U.S. residential mortgage securitizations. The definition of category 1 residential mortgage exposure, both as proposed by the Agencies and as we recommend it be revised, would treat as category 2 high-quality mortgages in many other jurisdictions that are well within common practice in those jurisdictions. We also do not believe the Agencies should attempt to address this issue by incorporating specific exceptions for identified countries in the definition of category 1 residential mortgage exposure; practices around the world are likely to be too diverse and complex. Instead, we urge the Agencies to add language to Section 32(g) permitting U.S. banks to use proposed-country risk weightings for residential mortgage exposures.

This is especially crucial where non-U.S. residential mortgage exposures underlie securitization exposures. It is even more implausible (and, arguably, inappropriate) that sponsors, issuers or servicers in other Basel III nations would build and maintain separate systems to assess how their residential mortgage exposures are characterized for U.S. risk-based capital purposes.

Fourth, and in addition to the principal recommendations set forth above, we urge the Agencies to make the following changes in its final rules addressing residential mortgage exposures.

- Section 32(g)(3) does not permit banks to recognize private mortgage insurance ("**PMI**") when calculating the LTV ratio of a residential mortgage exposure. The Agencies solicit comment (in Question 6) as to whether banks should be allowed to recognize PMI. We strongly believe that they should, both at the individual mortgage and pool-wide level. 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. We recognize, however, that some PMI providers are less financially sound than others and appreciate the need to develop a test for "qualified" PMI providers.

One approach would be to use the investment versus non-investment grade approach used in the Proposed Rules for other purposes. We would be happy to work with the Agencies to consider other alternatives.

- The safe harbor provided by Section 32(g)(4) of the Proposed Rules, which states that HAMP program loans are not deemed to be "modified" for purposes of the Standardized Approach provisions related to the risk weight of residential mortgage exposures, should be expanded to include other loan modification initiatives. Certain private, non-government sponsored initiatives can and are being structured, like HAMP, to provide meaningful solutions to the housing crisis by lowering monthly mortgage payments in order to make them more affordable and sustainable for the long-term. In light of the on-going economic challenges many homeowners face, we believe it is important, from a policy perspective, to not penalize banks from engaging in loan modifications both within the HAMP context and by undertaking other similar initiatives and programs, subject to the appropriate review of the relevant Agency.

**B. The Standardized Approach NPR's treatment of corporate exposures should be made more risk sensitive.**

As reflected in our other comments on the Standardized Approach NPR, we support the Agencies' effort to establish a more risk-sensitive replacement for the existing general risk-based capital rules. We believe increased risk-sensitivity should be extended to corporate exposures and recommend that the Agencies do so by applying more graduated risk weightings for corporate exposures, perhaps adopting in part the approach in the Amended Market Risk Rules in which the risk weighting for a particular corporate exposure depends upon its maturity and whether or not it is investment grade.

The approach taken in the Amended Market Risk Rules to corporate exposures contains certain flaws. However, we, along with several other associations, commented at length on the Agencies' notice of proposed rulemakings that resulted in the Amended Market Risk Rules.[142] The treatment of corporate exposures is one of a number of areas that the industry and the Agencies alike have acknowledged needs more consideration and refinement. However, pending development of a better approach, we believe that the Amended Market Risk Rules' approach, recognizing the correlation of risk with maturity and the investment grade as

[142] Letter from The Clearing House, *et al.* to the Agencies, February 7, 2012, regarding the notice of proposed rulemaking to incorporate into their proposed market risk capital rules alternative methodologies for calculating specific risk capital requirements for debt and securitization positions that do not rely on credit ratings.

opposed to non-investment grade dichotomy, is an improvement as compared to the rudimentary 100% risk weighting that should be incorporated into the Standardized Approach.

**C. The Standardized Approach NPR's treatment of retail exposures should be more granular and risk sensitive.**

As the Agencies concluded in connection with residential mortgage exposures, we believe that a granular approach should be taken to the risk weights for retail exposures more generally. Assigning the same capital charge to the most prime and the most subprime retail exposures (such as the most prime secured auto loans and the most subprime unsecured consumer loans) is simply not risk sensitive and does not further the objectives expressed in the NPRs. We look forward to discussing what risk weights and key risk factors would be appropriate to apply to retail exposures other than residential mortgage loans.

**D. The definition of high volatility commercial real estate should be narrowed in certain respects.[143]**

The Agencies note that "certain acquisition, development and construction loan exposures present unique risks for which the agencies believe banking organizations should hold additional capital."[144] The Standardized Approach NPR assigns a 150% risk weight to high volatility commercial real estate exposures ("**HVCRE**") as defined.

Although we agree with the premise that acquisition, development and construction loans can present higher risks, we believe that the Standardized Approach NPR's definition of the term HVCRE is overly inclusive.[145] Read literally, it would encompass a very broad scope of commercial real estate loans, including income-producing loans. We urge the Agencies to modify the definition in four respects.

First, a loan made to finance the acquisition, development or construction of real property should not be treated as a HVCRE once the project has progressed to the phase where it is generating sufficient income to service the bank's credit facility and the other cash flow needs of the property. A property may meet that test, of course, even when the credit facility

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[143] This Part IV.D is responsive to Question 8 of the Standardized Approach NPR.

[144] Standardized Approach NPR, at 52,901.

[145] The Standardized Approach NPR uses the same definition of HVCRE that is included in the Agencies' Advanced Approaches rules, both as they currently exist and as proposed to be amended by the Advanced Approaches NPR. Our comments on the scope of the term HVCRE in this section apply to the use of the term in the Advanced Approaches as well.

is initially extended. Consider, for example, a loan extended to finance the renovation of a portion of a commercial real estate facility. The proposed HVCRE definition, read literally, could encompass loans to finance renovation of an existing structure or project, irrespective of whether the loan is for a small renovation (and amount) relative to the project as a whole and irrespective of whether the project is generating cash flow that covers the financing and operating costs of the property. As such, we urge the Agencies to add a new clause (2)(iii) to the exceptions within the definition that are modified by the phrase "unless the facility finances", reading as follows: "(2)(iii) income producing properties, which are properties that [BANK] reasonably estimates have a debt service coverage ratio of at least 1.0 to 1.0."

Second, we request that the Agencies replace the clause "the real estate's appraised 'as completed' value" in clause (2)(ii) of the definition of HVCRE to read "the estimated total development costs through completion of construction and stabilization as approved by the lender." We believe replacing that phrase with a reference to the developer's estimated cost is a standard that is both conservative and more practical to implement.

Third, we submit that the definition of HVCRE explicitly exclude credit facilities for projects (x) financed by the Low Income Housing Tax Credit Program ("**LIHTC**") or (y) having on-going restrictions in relation thereto. LIHTC is an indirect Federal subsidy used to finance the development of affordable rental housing for low-income households. The use of LIHTC is encouraged in other federal regulation, including the Community Reinvestment Act. However, the use of LIHTC could effectively be discouraged or made more costly by the Proposed Rules.

LIHTC awards require that property owners accept and maintain on-going restrictions on rents that can be charged to certain tenants. Those rental restrictions have the effect of reducing project net operating incomes – and therefore the appraised values of those projects. Lower appraised values will tend to drive a higher percentage of these projects into the HVCRE category as currently defined. For LIHTC projects financed with tax-exempt bonds, other rules applicable to these same projects limit the ability to reduce loan-to-cost ratios below 50%. Because of significant downward pressure on rents (and therefore values) caused by the rental rate restrictions, it is frequently the case that loans with even moderate loan-to-cost ratios can still generate loan-to-value 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 upfront equity for purposes of the proposed 15% test.

The reduced rent levels position these LIHTC projects as relative bargains to prospective low-to-moderate income renters, so these rentals tend to be absorbed into the markets rapidly. These projects pose little market risk, and historic performance patterns would not fit a "volatile" label. Many such transactions also have pre-committed permanent takeout financing committed upfront to mitigate repayment risk. Accordingly, exclusion of LIHTC credit facilities would be appropriate from a risk perspective and also consistent with the community development equity exposures treatment of 100% risk weight.

Finally, we recommend that "other acceptable collateral" as defined in the Agencies' real estate lending standards[146] also be included as an acceptable form of borrowers' contributed capital in part 2(ii) of the definition. This addition would make the contributed capital requirement consistent with the loan-to-value ratio calculation from part 2(i) of the definition, which allows both readily marketable collateral and other acceptable collateral securing the extension of credit, including real estate purchased for purposes of the project in question, to be included. The real estate lending standards state that other acceptable collateral should be appropriately discounted consistent with the lender's practices for making loans secured by such collateral.

**E. The Standardized Approach NPR's treatment of past due exposures should conform to Basel II, both by defining past due exposures as net of specific provisions and applying Basel II's graduated risk weighting.[147]**

We agree that exposures that are 90 days or more past due or on non-accrual, all else being equal, represent greater risks than other exposures and do not object to the Agencies' proposal, in Section 33(k) of the Proposed Rules, to apply a higher risk weighting to these exposures. However, we urge the Agencies to conform the treatment of these exposures to the BIS' approach in Basel II's standardized approach (paragraph 75) in two respects.

First, we request that the Agencies expressly clarify in Section 32(k) that the amount of the exposure is calculated "net of specific provisions (including partial write-offs)." That is the formulation used in Basel II's standardized approach[148] in order to avoid the double counting that would otherwise occur by virtue of the dollar-for-dollar capital cost of specific provisions if the exposure were risk-weighted on a gross basis.

Second, we urge the Agencies to adopt for the standardized approach Basel II's graduated approach to past due exposures, with a 150% risk weighting if specific provisions are

[146] *See, e.g.*, 12 C.F.R., Part 365, Subpart A and Appendix A to Subpart A (OCC).

[147] This Part IV.E is responsive to Question 9 of the Standardized Approach NPR.

[148] Basel II, ¶ 75.

less than 20% the gross exposure, 100% if they are no less than 20% of the gross exposure and with supervisory discretion 50% if they are 50% or more of the gross exposure.

Basel II's approach to eliminating double counting as well as its graduated approach based on the level of specific provisions both support sound provisioning practices. We do not believe there is any reason for the Agencies' to diverge from the Basel Committee's approach on this issue, disadvantaging U.S. banks as compared to their international competitors.

**F. The 100% credit conversion factor assigned to exposures that, under the Standardized Approach NPR, would be deemed to be "Credit-enhancing representations and warranties" due to the elimination of the current general risk-based capital rules' exception for early-default and premium refund clauses is not justified and should be lowered to more properly reflect the actual risk posed by these exposures.[149]**

Under the Agencies' current general risk based capital rules, the definition of "Credit-enhancing representations and warranties" explicitly excludes exposures that contain early default and premium refund clauses for a period not to exceed 120 days from the date of transfer.[150] Freddie Mac's and Fannie Mae's newly published seller/servicer standards, which are to take effect in 2013, contain early default clauses to the extent a borrower fails to make any payments in the first three months after the loan is sold to the GSEs.[151] In addition, their current standardized seller/servicer agreements generally provide that the originator may, at the GSE's option, be required to refund any premium received in the event any underlying mortgage loan is refinanced or otherwise prepays within 120 days of the applicable funding or settlement date.[152]

While we acknowledge that these requirements do create some degree of economic exposure for an originating bank, we do not believe that the proposed 100% credit conversion factor for these types of exposures is justified in light of the actual risk posed by such provisions. Furthermore, for institutions with significant and on-going mortgage origination pipelines, this would result in significant and unwarranted increases in risk-weighted assets. In

[149] This Part IV.F is responsive to Question 10 of the Standardized Approach NPR.

[150] *See, e.g.*, 12 C.F.R., part 325, appendix A, § II.; *see also* Standardized Approached NPR, at 52,902.

[151] *See, e.g.*, Fannie Mae, *Selling Guide Announcement SEL-2012-08: New Lender Selling Representations and Warranties Framework* (Sept. 11, 2012), at 7, *available at* https://www.efanniemae.com/sf/guides/ssg/annltrs/pdf/2012/sel1208.pdf.

[152] *See* Freddie Mac Single Family Seller/Servicer Guide, § 8.13.

the experience of our members, refunds based on these 120 day early default and premium refund provisions have been rather limited. For eight of our member banks, the percentage of GSE deliveries that experienced early refinance/pre-payment within a 120 day period in early 2012 ranged from zero to two percent. Thus, the rate of early refinance/pre-payments that could trigger premium refunds has been quite limited even in an environment of historically low mortgage interest rates. In addition, the potential loss to a bank in such cases of early refinance/pre-payment would be the amount of the premium refunded, not the full amount of the loan to which we understand the credit conversion factor would be applied under the Standardized Approach NPR. Further, we believe it will likely be a rare occurrence where a borrower will miss all three payments after the loan is transferred and thus trigger Freddie Mac's and Fannie Mae's new early default provisions. This is further buttressed by industry-wide enhanced underwriting standards since the financial crisis.

As such, the Standardized Approach NPR's 100% credit conversion factor for exposures that are deemed to be credit-enhancing representations and warranties due to the presence of 120 day early-default and premium refund clauses – a risk weight equivalent to a category 1 residential mortgage loan with an LTV greater than 90%, for example – is not an accurate reflection of the actual economic risks posed by these exposures.

Finally, we believe there may be a technical glitch in the drafting of the Proposed Rules concerning credit enhancing representations and warranties. The preamble to the Standardized Approach NPR indicates that these should be treated as an off-balance sheet guarantee with a 100% credit conversion factor,[153] but the only use of the defined term itself in the text of the Proposed Rules appears to be in the definition of "securitization" which would seem to imply that a bank is supposed to use the SSFA with respect to such representations and warranties under the Standardized Approach. It is not clear whether that was the intended result in light of the language in the preamble or whether one could even technically apply the SSFA to such exposures.

[153] Standardized Approach NPR, at 52,902.

**G. All banks should be permitted, subject to regulatory approval, to use IMM for calculating exposure amounts for OTC derivatives, eligible margin loans, repo-style transactions and cleared transactions as a way to enhance the risk sensitivity of capital requirements for all banks.**[154]

Our members endorse the Agencies' stated "objective to enhance the overall risk-sensitivity of the calculation of a bank's total risk weighted assets."[155] We believe that incorporating the option, subject to regulatory approval, for all banks, including insured depository institutions, to be permitted to utilize IMM for calculating exposure amounts for OTC derivatives, eligible margin loans and repo-style transactions into the Standardized Approach would further this goal by allowing institutions that are not technically subject to the Advanced Approaches but nevertheless possess sufficient wherewithal to successfully implement and utilize a more appropriately risk sensitive approach with respect to these exposure amounts.

Under the Standardized Approach NPR, for example, the CEM is generally used to determine the exposure amount for OTC derivatives and in relation to the calculation of default fund contributions for QCCPs.[156] However, as we have noted above and in our previous letters, CEM is risk insensitive and results in an overstatement of the realistic economic exposure of derivative transactions, driven mostly by the calculation of PFE. We recognize that CEM has been historically utilized as part of the Basel accords from the beginning. However, we respectfully urge the Agencies to work with the BIS to generally revise CEM, including by working on developing a more risk-sensitive methodology of general applicability for determining these exposure amounts. We are, of course, also cognizant that developing and formulating such revisions to CEM is a challenging task from both an analytical and practical perspective and our members would welcome the opportunity to work with the Agencies and the BIS to formulate such revisions.

Nevertheless, the Advanced Approaches NPR and IMM do exist today as an alternative to CEM that is more risk sensitive and more closely aligns risk weights with actual economic exposure and thus furthers the Agencies' stated goal of enhancing risk sensitivity. Similarly, IMM would also enhance the risk sensitivity of the Standardized Approach NPR's provisions concerning collateral for eligible margin loans and repo-style transactions. Implementation of

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[154] This Part IV.G is responsive to Questions 11, 13 and 15 of the Standardized Approach NPR.

[155] Standardized Approach NPR, at 52,892.

[156] *See, e.g.*, Proposed Rules, § 34(a)(1) (setting forth the rules for determining the exposure amount for a single OTC derivative contract).

IMM can certainly be challenging in practice and will not be appropriate for all institutions. These practical difficulties, however, should not prevent banks from having the option to use IMM, subject to regulatory approval. There are undoubtedly some institutions that have the capacity to implement IMM with respect to OTC derivatives, eligible margin loans and repo-style transactions even though they do not meet the criteria for mandatory adoption of IMM under the Advanced Approached NPR. Allowing the use of IMM on an optional basis is also consistent with the Standardized Approach NPR's option of using the gross-up approach or the SSFA in connection with securitization exposures.

In this regard, we also readily acknowledge that IMM (and models more generally) have come under scrutiny in the wake of the financial crisis. Nonetheless, the areas where significant deficiencies were demonstrated during the crisis were quite limited, mostly dealing with the treatment of mortgage securitizations and correlation trading positions. It is also important to recognize that the deficiencies in models were not with respect to the models themselves but, instead, were principally with respect to one flawed assumption used in the models. This incorrect assumption in many bank and rating agency models was the failure to recognize that the assumed default rates and potential losses on mortgage and MBS were premised on historical data during periods (albeit relatively long periods) of only stable or rising housing prices, that housing prices could fall (potentially sharply), and that the consequences could be sharply increased defaults and losses. Moreover, Basel II.5[157] and the Advanced Approaches NPR reflect the lessons learned from the crisis, including with respect to IMM and, for example, OTC derivatives.[158]

Finally, we believe that providing the option for all banks to use IMM, subject to regulatory approval, would be consistent with the provisions of the Collins Amendment because doing so would not result in "minimum risk based capital requirements . . . for depository institutions holding companies . . . that are less than the generally applicable risk based capital requirements", as all depository institutions would also have the option to use IMM, subject to regulatory approval, under our proposal.[159]

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[157] *See* BIS and International Organization of Securities Commissions, *The Application of Basel II to Trading Activities and the Treatment of Double Default Effects* (April 2005); BIS, *Enhancements to the Basel II Framework* (July 2009); BIS, *Revisions to the Basel II Market Risk Framework* (July 2009); BIS, *Guidelines for Computing Capital for Incremental Risk in the Trading Book* (July 2009); and BIS, *Changes to the Revisions to the Basel II Market Risk Framework* (June 2010).

[158] *See, e.g.*, Advanced Approaches NPR, at 52,982.

[159] Dodd-Frank, § 171(b)(2).

### H. The Agencies should permit the use of supervisory-approved simplified VaR methodologies to calculate exposure amounts for repo-style transactions and eligible margin loans for purposes of the Standardized Approach.[160]

Consistent with the international Basel II standards, we strongly endorse the position that banks should be permitted to use simplified VaR methodologies, subject to regulatory approval, to calculate exposure amounts in connection with repo-style transactions and eligible margin loans subject to single product qualifying master netting agreements for purposes of the Standardized Approach. Simplified VaR methodologies are widely used today by many banks when calculating their counterparty credit exposures. This includes exposures to securities lending transactions in agency lending programs. These models have evolved over time based upon accumulated industry experience and regulatory oversight. They therefore represent a proven and realistic approach to the measurement of risk-based capital, in furtherance of the Agencies' stated objectives for the Standardized Approach.

Section 37 of the Proposed Rules would only permit the use by banks of the simple collateral approach or the collateral haircut approach (using either supervisory or a banks' own haircuts) for determining exposure amounts for repo-style transactions and eligible margin loans. Both of these methods are based on a series of standardized supervisory haircuts designed to approximate market price volatility and foreign exchange volatility. This includes a uniform 8% haircut for foreign currency mismatches, irrespective of the underlying currency pair. Given their inability to replicate risk mitigating factors inherent in VaR-based approaches, these methods produce exposure amounts far in excess of what prevails today under simplified VaR methodologies. As an example, neither method reflects the short duration of most securities lending transactions, or the strong correlation that exists between securities lent and collateral received. This is particularly problematic in the case of the non-U.S. securities lending markets, where the use of equity or other non-cash collateral is common.

We therefore believe that simplified VaR methodologies for the purposes of determining exposure amounts for repo-style transactions and eligible margin loans are far superior in assessing risk-based capital than the methods currently contemplated in Section 37 of the Proposed Rules. Simplified VaR methodologies are a practical and realistic alternative for many banks, regardless of size, given their common and well-understood features and inherent risk-sensitivity. Furthermore, the Agencies' prior approval requirement will ensure that simplified VaR methodologies are subject to proper implementation, maintenance and control by individual banks, including via back-testing and other validation tools. In addition, greater

[160] This Part IV.H is responsive to Question 14 of the Standardized Approach NPR.

standardization of simplified VaR methodologies can be obtained as required, via the use of properly calibrated supervisory inputs.

### I. The Proposed Rules should be modified to ameliorate the negative effects of the interaction between the equity exposure rules and the SSFA, particularly in the bank-owned life insurance ("BOLI") context.

Many banks use "separate account" BOLI to help offset the costs of providing highly competitive benefit plans to their employees.[161] A feature of BOLI is that insurance carriers establish legally separate accounts as part of the structure of the product that are generally outside the reach of the insurance carrier's general creditors. For a variety of reasons, including contractual limitations, tax concerns and practical and other considerations, banks often do not have the necessary data, including the granular information required for SSFA calculations, to use the Standardized Approach's full look-through provisions[162] in order to determine BOLI separate account risk weights, especially where securitization positions are involved.

As such, in order to determine the risk weights of the assets in these separate accounts, banks may be required to utilize the Standardized Approach NPR's simple modified look-through approach which would apply a risk weight to the entire value of the BOLI policy equal to the highest risk weight for any one asset permitted in the separate account based upon the insurance carrier-established investment guidelines that govern the account.[163] The alternative modified look-through approach would apply a risk weight to the entire value of the policy equal to the pro rata risk weight of the investments permitted in the separate account based upon the insurance carrier-established investment guidelines that govern the account, while assuming the most risky assets are invested in first if the various investments limits add up to more than 100%.[164] Under both approaches, the reference point for calculating the risk-based capital is the carrier-established investment guidelines.

Many of these investment guidelines, however, include the ability to invest in private label and other securitizations. Of course, because these are hypothetical exposures, the bank

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[161] *See* OCC, FDIC and Office of Thrift Supervision, *Interagency Statement on the Purchase and Risk Management of Life Insurance* (2004) (stating that "BOLI can be an effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement plans." The importance of BOLI investments was also recognized in the proposed regulations to implement the Volcker Rule which specifically exempted BOLI from the "covered fund" restrictions thereof).

[162] *See* Proposed Rules, § 53(a).

[163] *See* Proposed Rules, § 53(c).

[164] *See* Proposed Rules, § 53(c).

itself will never have the data required to calculate the appropriate risk weight under the SSFA and will therefore be required to assign a 1,250% risk weight to these exposures.[165] We believe this would result in a gross overstatement of the risk weight applicable to BOLI portfolios in relation to the actual economic exposure involved and is a presumably unintended artifice of the interaction among the SSFA and the equity exposure rules in the Standardized Approach NPR.

In light of the foregoing, we urge that the Proposed Rules be modified in two ways. First, the Agencies should also provide for another look-through approach whereby the risk weights for the underlying BOLI separate account investments would be determined on a *pro rata* basis based on the actual percentage balance of different investment classes present in the separate account at the relevant time of calculation. We believe this type of data may be easier for banks to obtain and more practical to use for purposes of these determinations. Second, to deal with situations where actual asset class allocations are not readily available, the Proposed Rules should be revised to state that funds whose investment guidelines specify that the fund invest only in bank-eligible securities and that the fund invest no more than 30% of its total market value in private securitizations should receive a risk weight of 100% for the *pro-rata* share of the fund invested in private securitizations. If the fund does not meet these guidelines, the currently proposed securitization treatment would apply.

We believe the foregoing would go a long way towards ameliorating the negative effects of the interaction between the equity exposure provisions and the SSFA in the Standardized Approach NPR, while ensuring that banks hold an amount of capital that is commensurate to the risk posed by the assets held in BOLI separate accounts.

**J. The Agencies should apply the same 20% risk weight to securities firms that would apply to banks. At a minimum, the risk weight should be much lower than 100%.**

The Standardized Approach NPR would risk weight exposures to securities firms as corporate exposures, using a 100% risk weight, increasing by a factor of five relative to the 20% risk weight applied to banks and bank holding companies. We believe that a 100% risk weight is inconsistent with the risk profiles associated with securities firms. We also believe a 100% risk weight is a source of international inconsistency between the U.S. implementation of the Basel III rules and other regions. Registered broker-dealers are subject to very similar prudential regulation as are banks and other financial institutions; the risk profiles of broker-dealers are much more similar to those of regulated banks than they are to those of

[165] *See* Proposed Rules, § 43(a).

unregulated corporate entities. As such, we ask that the Agencies apply the same 20% risk weight to securities firms that would apply to banks. At a minimum, the risk weight should be much lower than 100%.

### K. The existing 50% risk weight ceiling on OTC derivative contracts should be retained.[166]

Under the existing general risk-based capital rules, the risk weight applied to an OTC derivative contract is limited to 50%. The Proposed Rules remove this risk weight ceiling, because, according to the Agencies, "the types of counterparties acceptable to participants have expanded to include counterparties that merit a risk weight greater than 50%."[167]

The Associations believe the 50% risk weight cap should remain in place, especially in light of the shortcomings of the CEM. As discussed above and commented on at length by The Clearing House and others,[168] the CEM does not accurately measure exposures and requires reform. The 50% risk weight ceiling mitigates these concerns by capping the effect of an imprecise CEM calculation on the overall capital calculation. Removal of the 50% risk weight ceiling would eliminate an important check on the CEM's inherent lack of risk sensitivity.

### L. Standard supervisory haircuts should be harmonized with international rules and supported by actual price volatility experience.

The Standardized Approach NPR proposes to apply a 25% standard supervisory market price volatility haircut to all collateral other than sovereign debt securities that receive 100% risk weight under the Standardized Approach. This method is risk-insensitive and more than double the applicable Basel standard, which dictates a haircut ranging from 1% to 12% based on rating agency rating. We recommend an approach that allocates eligible collateral into groupings based on tenor and applies haircuts that are supported by price volatility experience for those assets during a stress period. For example, we believe that following haircuts based on tenor are appropriate:[169]

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[166] This Part IV.K is responsive to Question 11 of the Standardized Approach NPR.

[167] Standardized Approach NPR, at 52,904.

[168] *See, e.g.*, TCH DFA Section 165 Comment Letter, Annex C (commenting on aspects of the proposed rules regarding single-counterparty credit limits, including the use of the CEM in the proposed rules' calculation methodology).

[169] Source of data: Pricing Direct and JPM Research.

| Corporate Bond Ratings | Observed Pricing Volatility by Maturity | | | |
|---|---|---|---|---|
| | 1YR | 5YR | 10YR | 30YR |
| AA | 2.25% | 3.07% | 4.02% | 5.98% |
| A | 1.80% | 3.89% | 5.38% | 6.96% |
| BBB | 3.42% | 5.15% | 5.82% | 7.91% |
| Proposed in NPR | 25% | 25% | 25% | |
| **Our Proposal** | **3%** | **6%** | **12%** | |

## M. We are supportive of the Agencies' re-examining risk weights for certain revenue obligation municipal exposures.

The Associations are aware that one of our members is contemporaneously submitting a comment letter to the Agencies supported by empirical data that, *inter alia*, addresses the Standardized Approach NPR's risk weight for certain municipal exposures and argues that the risk weight for certain classes[170] of municipal revenue exposures backed by revenue bonds should be risk weighted 20% (instead of the Standardized Approach's current 50% risk weight) because such classes have historically performed similarly to general obligation municipal exposures, which are risk weighted 20% under the Standardized Approach NPR. Although the Standardized Approach NPR's risk weight distinction between general obligation and revenue bonds is carried over from the general risk-based capital regime currently in place, we are supportive of the Agencies' re-examining this issue in the interests of enhancing risk sensitivity within the confines of the requirements of Section 939A of Dodd-Frank.

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[170] For example, revenue bonds in transaction amounts greater than $25 million that are not classified as industrial revenue bonds, including land-secured bonds and private activity bonds, housing, healthcare, retirement issuers, including private healthcare/higher education, tobacco settlement, gas prepay and student loan bonds.

## V. Advanced Approaches NPR[171]

### A. The Advanced Approaches NPR uses extraordinarily narrow triggers for events giving rise to an increased minimum holding period or margin period of risk for certain netting sets and should be revised, including via the incorporation of a materiality standard.[172]

The Proposed Rules, like Basel III, require a bank to assume a holding period or margin period of risk of 20 business days for netting sets if (i) the number of trades exceeds 5,000 at *any time* during the quarter (except where the counterparty is a CCP or the netting set consists of cleared transactions with a clearing member), (ii) *one* or more trades involves illiquid collateral posted by the counterparty, or (iii) the netting set includes *an* OTC derivative that cannot be easily replaced. Moreover, if over the two previous quarters more than *two* margin disputes in a netting set have occurred that lasted more than the holding period, then the bank must adjust the supervisory haircuts upward for that netting set on the basis of a holding period that is at least *two times* the minimum holding period.

As an initial matter, we believe that the required use of a longer holding period or margin period of risk for netting sets with more than 5,000 transactions does not serve as an effective proxy for risk. The size of a netting set that may warrant a longer supervisory imposed holding period in order to account for possible delays in settlement or close out of collateralized transactions is primarily a function of the specific asset class and the position's size relative to transacted volumes. It is also a function of the particular bank's role in the capital markets. Even accepting, however, that from a supervisory perspective it may be sensible to identify a specific threshold wherein an increased holding period should apply, the imposition of such an increase on the basis of any single breach above the intended threshold in a given quarter is disproportionate and will result in unwarranted fluctuations in required risk-based capital.

To address these concerns, we recommend several modifications to the proposed rule. First, it should be clarified by the Agencies that the 5,000 netting set threshold is meant to apply on the basis of market-facing transactions, rather than on the basis of the internal allocation of transactions among a bank's individual clients. Second, in order to dampen excessive volatility we strongly recommend that the 5,000 netting set threshold be calculated on a quarterly-average basis rather than on the basis of any single breach of the threshold in a

[171] In addition to the comments in this Part V, we have commented on the Advanced Approaches NPR's securitization provisions in Part III.A and CCP provisions in Part III.B.

[172] This Part V.A is responsive to Question 2 of the Advanced Approaches NPR.

given quarter. Third, each bank should be permitted to determine based on relevant circumstances, including the type of collateral pledged and the bank's evaluation of its capital and liquidity positions, that a threshold breach is material.

Furthermore, each of the standards proposed by the Agencies is extraordinarily narrow and unnecessarily rigid. As an example, the inclusion of illiquid collateral for a single trade or the inclusion within a netting set of a single OTC derivative that cannot be easily replaced may be manifestly immaterial to the bank's capital position, taking into account, among other factors, the notional amount of the relevant trade compared to the other trades in the netting set. We therefore strongly urge the Agencies, as to each of these standards, not to require a bank to apply the longer holding period or margin period of risk if the bank concludes that the consequence of crossing the threshold is immaterial to its capital and liquidity positions (an "**immateriality determination**"). In order to assure the Agencies that banks will be disciplined in reaching that determination, we suggest that the Agencies provide that a bank may not make an immateriality determination greater than a specific threshold, for example, 1%, without prior regulatory approval.

Finally, insofar as margin disputes are concerned, we urge the Agencies not to include in the Proposed Rules the automatic doubling of the supervisory floor for netting sets where there have been more than two margin call disputes during the previous two quarters that lasted longer than the holding period. Instead, we believe the final rule should permit banks discretion in determining whether to adjust the minimum holding period and in what manner (*i.e.*, discretion as to both the amount of the adjustment and the time period during which it would apply) if there have been more than two margin disputes with the counterparty in the netting set during the two previous quarters that lasted longer than the holding period. Legitimate disagreements between counterparties can occur, and banks need to consider the dynamics of those disagreements both as pledgor and pledgee in affected transactions. An automatic doubling of the minimum holding period inevitably would incentivize banks not to assert what are customarily good faith disagreements that are resolved in the ordinary course, potentially causing banks to forego an honest and accurate evaluation of collateral positions in order to avoid disputes and the increased cost of dealing with the other affected counterparty if the two-dispute threshold is crossed. We strongly believe that each bank should be permitted to establish its own margin dispute resolution process and determine the consequences of multiple margin disputes occurring with a particular counterparty, taking into account the nature of the dispute, the type of collateral pledged, and its experience with other counterparties involving similar collateral.

### B. The Advanced Approaches NPR's provision implementing Basel III's increased asset value correlation factor for exposures to credit institutions should conform to Basel III and apply a 0.12 factor to *e* instead of the 0.18 factor set forth in Section 131(e) of the Proposed Rules.

Basel III introduced a multiplier of 1.25 to the correlation factor for wholesale exposures to unregulated financial institutions and regulated financial institutions with consolidated assets of greater than or equal to $100 billion (for purposes of this Part V.B, "**covered financial institutions**").[173] The Agencies implemented the 1.25 multiplier in the formula provided in Table 1 of Section 131 of the Proposed Rules, but with one important difference from Basel III: where the Basel III formula multiplies *e* (which is the base of the natural logarithms) by 0.12, Table 1 in Section 131 would multiply *e* by 0.18 in determining the capital requirement for exposures to covered financial institutions (which is the same adjustment factor historically applied in determining the correlation factor for HVCRE).

The Agencies did not comment in the preamble to the Advanced Approaches NPR on the use of an 0.18 instead of 0.12 adjustment factor for exposures to covered financial institutions and it is unclear as to whether this is simply an unintended error. We strongly believe the Agencies should revert to the 0.12 adjustment factor provided in Basel III. The change from a 0.12 to 0.18 adjustment factor would have a very material impact on exposures to covered financial institutions and should not be implemented – certainly not without a discussion of the reasons and the quantitative support. Consider, for example, a $100 million loan to a large, regulated financial institution for which the LGD is 50% and the PD floor of 0.03% is applied. The risk weight would be 39% for a 0.12 adjustment factor and 53% using a 0.18 adjustment factor. Stated alternatively, a U.S. bank would need to hold an additional $1.12 million in capital (assuming an 8% capital ratio) for the same exposure as a non-U.S. bank. We note that the impact worsens as the PD is increased. Now consider the same loan, but with a PD of 2.42% applied. In this case, the risk weight would be 208% for a 0.12 adjustment factor and 231% using a 0.18 adjustment factor. The capital requirement for this U.S. bank is $1.84 million (assuming an 8% capital ratio) greater for the same exposure as a non-U.S. bank.

We urge the Agencies to conform the final rules adjustment factor for *e* to the 0.12 adjustment factor in Basel III.

[173] Basel III, ¶ 102 (amending paragraph 272 of Basel II).

### C. An Advanced Approaches bank that falls below the $250 billion consolidated total assets or $10 billion foreign exposures threshold, as applicable, should no longer be subject to the Advanced Approaches.[174]

The Advanced Approaches NPR would add a "Hotel California" provision requiring that a bank, once it crosses the threshold for becoming subject to the Advanced Approaches, must continue to calculate capital as an Advanced Approaches bank unless and until the appropriate Agency determines in writing that continued application of the Advanced Approaches to that bank is no longer appropriate, even if the bank falls below the applicable thresholds. We believe this provision should not be added to the Advanced Approaches rules.[175]

There are three reasons that lead us to this view. First, and most fundamentally, banks should and do continually re-evaluate their business plans. Changes in business plans may result in the disposition or downsizing of businesses, which could have the consequence of consolidated total assets falling to less than $250 billion for a bank that previously had a larger balance sheet or, in a case where the bank decides to dispose of all or a substantial part of its non-U.S. operations, foreign exposures falling to less than $10 billion where they had previously exceeded $10 billion. There is no reason why a bank that falls below those thresholds should be required to continue calculating capital under the Advanced Approaches when a competitor (in theory, a direct competitor with an identical business plan and substantially the same amount of consolidated total assets and foreign exposures) is not required to apply the Advanced Approaches. Adopting a different standard for becoming subject to the Advanced Approaches versus exiting the Advanced Approaches requirements implies that the standards for becoming subject to the Advanced Approaches are themselves defective. We do not believe they are.

Second, the expenses incurred by a bank to implement compliance with the Advanced Approaches are millions of dollars, devoted both to staffing needs and systems development. We do not believe the Agencies should be concerned that a bank whose consolidated total assets or foreign exposures are near the $250 billion or $10 billion threshold, as applicable, will choose to migrate in and out of the Advanced Approaches on a period-to-period basis as its assets or foreign exposures rise above or fall below those thresholds or, more importantly, without due consideration opt out of the Advanced Approaches. The "sunk" costs of

[174] This Part V.C is responsive to Question 17 of the Advanced Approaches NPR.

[175] Proposed Rules, § 100(a)(2). This provision is not in the Agencies' existing Advanced Approaches rules and, in our view, should be deleted. The provision is not discussed in the preamble to the Advanced Approaches NPR.

implementing compliance are simply too great for a bank to opt out of the Advanced Approaches lightly.

Third, as discussed in Part III.C, a bank that has been applying the Advanced Approaches but whose consolidated total assets or foreign exposures fall below the $250 billion and $10 billion thresholds, as applicable, has sound reasons for wanting to cease advanced approach's calculations – to avoid the proliferation of capital ratios that the bank becomes subject to as a result of the Collins Amendment and to simplify public disclosure concerning its capital position relative to minimum requirements.

In short, we strongly believe that the Advanced Approaches should not restrict the ability of banks that fall below the $250 billion and $10 billion thresholds to opt-out of the Advanced Approaches and benefit from a more simple and direct capital reporting regime.

**D. The Advanced Approaches NPR's elimination of the existing 7% risk weighting for equity exposures to money market funds will result in a punitive risk weighting for bank exposures to these funds unless the new rules are modified to accommodate the unique circumstances of these funds.**[176]

Section 54(e) of the Agencies' existing Advanced Approaches rules permit banks to apply a 7% risk weighting to equity exposures in money market funds subject to Rule 2a-7 under the 1940 Act (such funds "**Rule 2a-7 Funds**") if, as to each such fund, the fund has "an applicable external rating in the highest investment-grade rating category." The Advanced Approaches NPR eliminates this provision, with the consequence that Advanced Approaches banks must calculate capital charges for exposures to Rule 2a-7 Funds under one of three approaches – the full look-through approach, the alternative modified look-through approach, or the simplified look-through approach. The Agencies comment in the preamble to the Advanced Approaches NPR that they have proposed changes in the treatment of Rule 2a-7 Funds because these funds demonstrated at times elevated credit risk, and note that under Section 154 of the Proposed Rules the risk weight for Rule 2a-7 Funds is subject to a 20% floor.[177]

Although we agree that it is appropriate to re-consider the regulation of Rule 2a-7 Funds (including the regulatory capital treatment of investments in those funds by banks), addressing the issue by simply removing the existing Section 54(e) from the Advanced Approaches rules will result in a punitive risk weighting for an asset class that is heavily regulated and does not warrant a punitive treatment. The reason for this result is that (i) both the full and the

[176] This Part V.D is responsive to Question 7 of the Advanced Approaches NPR.

[177] The text of Proposed Rule Section 154 does not appear to address the 20% floor.

alternative modified look-through approach will produce inflated risk weightings, and (ii) the simple modified look-through approach will produce greatly exaggerated risk weightings, in each case because they fail to take into account the reduced risk resulting from the short-term nature of the underlying exposures as required by Rule 2a-7 (with the impact, of course, being most severe under the simplified look-through approach because of its requirement that the bank use the highest risk weight assigned to any exposure the Rule 2a-7 Fund is permitted to hold).

We urge the Agencies to apply a 20% risk weight to investments in Rule 2a-7 Funds, at least for the time being and pending finalization of the new approaches to regulation of Rule 2a-7 Funds that are currently being considered. Three considerations support this view.

First, the Proposed Rules fail to take into account the short-term nature of exposures to Rule 2a-7 Funds arising out of the limitations on the investments that such funds may make. The Agencies have, of course, recognized the relevance of maturity to risk weightings in the approach that the Amended Market Risk Rules adopt for corporate exposures (and in Part IV.B, we have urged the Agencies to consider for the treatment of corporate exposures under the Standardized Approach).

Second, notwithstanding the extraordinary amount of attention that the "breaking the buck" issue (*i.e.*, having a net asset value of less than $1.00 per share) received during the financial crisis, the only Rule 2a-7 Fund to ever have a net asset value of less than $1.00 per share was the Reserve Fund because of its holdings of Lehman Brothers debt securities, and even in that case the loss taken by investors was small – approximately $.0025 per $1.00.

Third, since 2010 Rule 2a-7 Funds have been subject to substantially enhanced credit, liquidity and transparency safeguards under amendments to Rule 2a-7 under the 1940 Act adopted by the SEC.[178] In addition, both the SEC for Rule 2a-7 Funds and the Financial Stability

[178] These enhanced safeguards, which were implemented in 2010, include the following, among others: reducing permissible Rule 2a-7 Fund investments in second-tier securities by lowering the permitted percentage of a Rule 2a-7 Fund's "total assets" that may be invested in second-tier securities from five percent to three percent; lowering the permitted concentration of a Rule 2a-7 Fund's total assets in second-tier securities of a single issuer from the greater of one percent or $1 million to one-half of one percent; further restricting the maturity limitations on a Rule 2a-7 Fund's portfolio in order to reduce the exposure of Rule 2a-7 Fund investors to certain risks, including interest rate risk, spread risk and liquidity risk (*e.g.*, reducing the maximum weighted average portfolio maturity permitted by Rule 2a-7 from 90 days to 60 days in certain cases and mandating stress testing of the 2a-7 Fund); requiring that each Rule 2a-7 Fund hold securities sufficiently liquid to meet reasonably foreseeable shareholder redemptions in light of its obligations under section 22(e) of the 1940 Act and any commitments made to shareholders; and prohibiting a Rule 2a-7 Fund from acquiring illiquid securities if,

(continued...)

Board for equivalent international funds are considering additional rules or amendments which may further reduce risk exposure of these funds.[179]

In the short term, we strongly urge the Agencies not to introduce an unnecessarily exaggerated change in the risk weighting of exposures to Rule 2a-7 Funds. These investments continue to be very low risk, both because of the short-term nature of the underlying exposures owned by the Rule 2a-7 Funds and because of regulatory improvements.

### E. OTC derivatives with central banks, multilateral development banks ("MDBs") and other similar entities should be excluded from the capital requirement for credit valuation adjustments (the "CVA capital requirement").[180]

The Associations believe the Agencies should exclude OTC derivatives with central banks, MDBs and other similar counterparties that receive a zero risk weight from the CVA capital requirement (for example, foreign sovereigns whose exposures receive a zero risk weight under the country risk classification methodology). This exclusion would be appropriate in view of the low credit risk of exposures to these entities,[181] as well as their capital treatment elsewhere in the Proposed Rules. For example, MDBs receive a zero percent risk weighting under the Standardized Approach NPR; the standardized measurement method under the Amended Market Risk Rules assigns a zero specific risk weighting factor to a debt position that

(...continued)
immediately after the acquisition, it would have invested more than five percent of its total assets in illiquid securities. *See* 12 C.F.R. §§ 270.2A-7(a)(27), (c)(2)(ii), (c)(2)(iii), (c)(4)(i)(C), (c)(5), (c)(10)(v).

[179] *See, e.g.*, Financial Stability Board, *Strengthening the Oversight and Regulation of Shadow Banking: Progress Report to G20 Ministers and Governors*, at 4, 5 (Apr. 16, 2012) (discussing, among other things, possible policy options to enhance the soundness of money markets and address systemic vulnerabilities of money market funds), *available at* http://www.financialstabilityboard.org/publications/r_120420c.pdf. *See also* Technical Committee of the International Organization of Securities Commissions, *Money Market Fund Systemic Risk Analysis and Reform Options: Consultation Report* (Apr. 27, 2012) *available at* http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf.

[180] This Part V.E is responsive to Question 4 of the Advanced Approaches NPR.

[181] With respect to the capital treatment of MDBs, the Agencies stated that "[a zero risk-weight] 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." Standardized Approach NPR, at 52,896.

is an exposure to an MDB;[182] and, under both the current Advanced Approaches rules and the Proposed Rules, exposures to MDBs are exempt from the 0.03% PD floor.[183]

### F. Added flexibility should be provided in the determination of credit spread factors for purposes of the CVA VaR calculation.[184]

Credit spreads factor into CVA VaR calculation in two ways: (i) in the calculation of credit spread sensitivity and (ii) in scenario generation. Under Section 132(e)(6)(ii) of the Proposed Rules "if a CDS spread is not available, the bank must use a proxy spread based on the credit quality, industry and region of the counterparty," the methodology employed being the same as the approved methodology for credit specific risk in the VaR model. Unlike market risk VaR, where proxying is the exception, for CVA VaR, many banks have portfolios of counterparties that extend well beyond those with a publicly available credit spread curve. Proxying a CDS spread for CVA VaR is the norm rather than the exception.

These two components of the CVA VaR calculation have different purposes and should not necessarily have the same proxy methodology. The former is an approach for determining a spot curve when marking the CVA and generating the credit spread sensitivity. In this process, if a credit spread curve is not publicly available, the proxy methodology will generally rely on an internal process that reflects the best assessment of credit quality (as it is likely that a public rating is also unavailable) to map to market observed spread levels. It is not necessarily based on a granular breakdown of credit quality, industry and region, nor is it necessarily the same approach as utilized in the approved credit specific risk model. The latter is an approach for determining the historical time series for scenario generation. In this process, if a credit spread curve is not publicly available, the proxy methodology aims to capture the historical moves that best reflect the risk of the position.

We believe that the proposal is unnecessarily prescriptive and does not reflect the diverse range of industry practices regarding CVA. In addition, many firms would need to create new processes with the sole function of dealing with regulatory CVA, which would come at a significant cost and would be inconsistent with risk management and internal CVA marking processes. We respectfully propose that the Agencies adopt a more flexible framework, which allows banks to use the methodology of their choice, subject to supervisory review and a set of

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[182] Amended Market Risk Rules, § 10(b)(2)(ii).

[183] *See, e.g.*, 12 C.F.R. Part 225 Appendix G, § 31(d)(2).

[184] This Part V.F is responsive to Question 4 of the Advanced Approaches NPR.

minimum standards that support the existing VaR practices, existing internal CVA marking practices, and risk management framework.

### G. Banks should have greater flexibility in the determination of $LGD_{MKT}$.

The Proposed Rules require that, for the determination of $LGD_{MKT}$, the loss given default of the counterparty be based on the spread of a "publicly-traded debt instrument" of the counterparty, or, where a publicly-traded debt instrument spread is not available, a proxy spread based on the credit quality, industry, and region of the counterparty. In contrast, under paragraph 94 of Basel III, as well as under Article 373 of Proposed CRD IV, the comparable requirement is that $LGD_{MKT}$ be based on the spread of a "market instrument" of the counterparty.

We believe that the Proposed Rule's approach is unduly prescriptive and prevents banks from using more effective methods for determining $LGD_{MKT}$. We urge the Agencies to also permit banks to determine $LGD_{MKT}$ in accordance with preexisting policies, procedures and methodologies that have been approved by the applicable primary regulator. For example, such determinations could be based on the spread of another market instrument as explicitly permitted by Basel III and Proposed CRD IV or other methodologies which take into account parameters such as market observable recovery rates on unsecured bonds, relative comparisons between loan and bond recovery rates and structural components of the derivative. Furthermore, we believe this approach represents a conceptually congruent extension of the additional guidance in this area.[185]

### H. For purposes of the shortcut method to capture the effect of a collateral agreement, maturity should equal the notional weighted average maturity ("WAM") of all transactions in the netting set, rather than the greater of the notional WAM and the maximum of half of the longest maturity occurring in the netting set.

In cases where a bank uses the shortcut method to capture the effect of a collateral agreement when estimating exposure at default using IMM, the bank must calculate the expected exposure ("**EE**") for the counterparty using that method and keep that EE constant, with the maturity equal to the maximum of half of the longest maturity occurring in the netting set, and the WAM of all transactions in the netting set. We believe that WAM is a more appropriate metric in that it takes into account a long position without inappropriately over-weighting. For example, suppose there were three equal exposures comprising a netting set.

[185] *See* BIS, *Basel III Counterparty Credit Risk—Frequently Asked Questions* (July 2012), at 9 (Question 2b.5).

One had a 30-year maturity and the other two had 6 month maturities. Using the rule as proposed, half of the longest maturity or 15 years, is much greater than the WAM.

* * *

The Clearing House and ASF appreciate your consideration of the views expressed in this letter. If you have any questions, please contact me at (212) 613-9883 (email: david.wagner@theclearinghouse.org) or Tom Deutsch of the ASF at 212-412-7107 (email: tdeutsch@americansecuritization.com).

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# TABLE OF CONTENTS


I. Executive Summary ........ 4

II. Basel III NPR ........ 8

A. The Associations continue to believe that four of Basel III's adjustments to common equity Tier 1 should be modified in certain respects. ........ 8

1. AOCI ........ 9

2. MSAs ........ 16

3. DTAs ........ 18

a. *Banks should be permitted to continue the administrative practice of measuring DTAs that could be realized through loss carrybacks by comparing the relevant DTAs to the taxes paid in the relevant carryback period (and not by scheduling out the estimated future reversal of the relevant temporary differences).* ........ 18

b. *Banks should treat DTAs in the same fashion that they treat DTLs in making capital deductions and adjustments under the Basel III NPR.* ... 21

c. *Banks should be able to elect to net or not to net deferred taxes with the associated assets and liabilities that are subject to capital deduction or adjustment under the Basel III NPR and that election should be made separately on a given reporting date for each different item (including, during the transition period, items reported in AOCI).* ........ 22

d. *Banks should be permitted to choose to gross up the DTLs embedded in the asset value of leveraged leases accounted for pursuant to the purchase accounting provisions in ASC paragraphs 840-30-25 through 35 as provided in the Current Rules.* ........ 26

4. Significant and Non-Significant Investments in Financial Institutions ........ 27

a. *The definition of "financial institution" should be revised to encompass only "regulated financial institutions" as defined in the Proposed Rules and designated as SIFIs regulated by the Federal Reserve under Title I of Dodd-Frank.* ........ 27

b. *Trading book exposures should be calculated based on deltas, as required by the Amended Market Risk Rules, or failing that, the Agencies should consider other changes to reflect the true nature of trading book exposures, such as decreasing the residual maturity requirement for short positions in the trading book, exempting positions in broad market indices, and exempting physically-settled equity derivatives.* ........ 34

B. The application of the minority interest limitations on Additional Tier 1 and Tier 2 capital instruments issued by depository institution subsidiaries of bank holding companies and real estate investment trust ("REIT") preferred and similar securities is inappropriate in the U.S. context. ........ 37

1. The limitation on the recognition of Additional Tier 1 and Tier 2 capital issued by depository institution subsidiaries would serve to significantly curtail a unique and important source of cost-effective funding for U.S. banks and should be eliminated for these instruments. .................................................... 37

2. REIT preferred and similar securities should not be subject to the minority interest limitations because they do not, by virtue of their exchange feature, pose the same loss absorbency issues as other forms of minority interests, while simultaneously preserving the only presently available tax-deductible Additional Tier 1 instrument for U.S. banks. .................................................... 39

C. The regulatory capital components – common equity Tier 1 capital, Additional Tier 1 capital and Tier 2 capital – defined in Section 20 of the Proposed Rules require modification to accommodate U.S. corporate law and practices. .................................. 40

1. CET1. ........................................................................................................ 41

2. Additional Tier 1 Capital. ................................................................................... 43

3. Tier 2 Capital. ......................................................................................... 45

4. Additional Comment on Regulatory Capital Components. ................................ 47

D. Capital Buffers.......................................................................................................... 47

1. The Agencies should, in practice, use their discretion in a reasonable, timely and judicious manner to permit distributions otherwise prohibited by the operation of the Capital Conservation Buffer in order to prevent the creation of another *de facto* minimum capital requirement in contradiction to the express intent of Basel III.......................................................................... 47

2. The definition of "eligible retained income" for purposes of Section 11 of the Basel III NPR should be revised to eliminate the double counting of items already deducted from regulatory capital such as goodwill and other intangibles that flow through net income under U.S. GAAP. ............................. 49

3. The Agencies should approach activation of the Countercyclical Capital Buffer with a great degree of caution and circumspection given the various analytical and practical challenges and potential flaws in its design and implementation. 50

E. The Agencies should <u>not</u> incorporate into their capital rules the Basel III leverage ratio until Basel III's parallel run period that continues until January 1, 2017 has lapsed and, in any event, should never subject a single bank to multiple leverage ratios................. 53

1. Timing Considerations. ......................................................................... 53

2. Single Leverage Ratio. ......................................................................... 54

3. Substantive Concerns. ......................................................................... 54

F. The definition of "Advanced Approaches [BANK]" should be clarified not to include institutions that are still in the Advanced Approaches parallel run. ................................ 56

III. Concerns Cutting Across the NPRs.............................................................................. 57

A. The securitization framework should be modified in certain respects in order to address misaligned incentives and opportunities for regulatory arbitrage. .................... 57

1. The amount of risk-based capital required to be held against securitization exposures subject to the 1,250% risk weight should be capped at the amount of those exposures (a dollar-for-dollar cap). .................................................... 57

2. The risk-based capital charge for any omission or other failure in fulfilling the yet-untested due diligence requirements should be based on the circumstances instead of being immediate, automatic, irreversible and highly punitive. ........................................................................................................ 59

3. The definition of resecuritization should be clarified in one instance and revised in another in order to avoid incentives and outcomes that do not further the policy objectives of the Proposed Rules. ........................................ 60

4. The amount of any off-balance sheet securitization exposure should be capped at the maximum potential amount that the bank could be required to fund given the securitization SPE's underlying assets (calculated without regard to the current credit quality of those assets)........................................................ 62

5. The apparent technical glitch in Section 144(b)(1) of the Proposed Rules should be fixed to properly refer to the Standardized Approach. ................................ 63

6. Student-status deferments should not be considered contractually deferred interest payments in the computation of parameter W under the SSFA............ 64

7. The definition of "financial collateral" should continue to include conforming residential mortgage exposures and some non-investment-grade securitization exposures.................................................................................................... 65

B. We urge the Agencies to revise the NPRs' treatment of exposures to central counterparties to include the interim framework released by the BIS in July 2012 and, going forward, to work expeditiously with other national regulators to address other concerns with the BIS' and the Agencies' approach....................................................... 66

C. U.S. banks – particularly Advanced Approaches banks – will be subject to a proliferation of capital ratios, creating market confusion as to inter-relationships among ratios and which ratio is the binding constraint for an individual bank, as well as entailing substantial expense. It is critically important that the Agencies and other policy makers ultimately address this complex array of ratios by developing a more direct and rational approach, even if requiring legislative action. ................................. 68

D. Banks should be able to recognize economically effective hedge pairs in accordance with policies and procedures that are subject to regulatory review and approval irrespective of whether the equity securities are publicly traded. ................................ 70

IV. Standardized Approach NPR ........................................................................................ 71

A. The Standardized Approach NPR's treatment of residential mortgage exposures should be revised to (i) recognize that not all junior lien exposures are higher risk and, accordingly, accommodate inclusion of non-"piggy-back" junior liens in category 1, (ii) treat low-risk interest only loans as category 1, (iii) recognize the difficulties (and in some cases impossibility) of applying the new regime to outstanding residential mortgage loans by continuing to apply the existing 50%/100% risk-weighting approach to those loans, and (iv) accommodate differences in lending standards in other countries by permitting banks to use the risk weightings of national regulators in OECD countries. .......... 72

B. The Standardized Approach NPR's treatment of corporate exposures should be made more risk sensitive. .......... 80

C. The Standardized Approach NPR's treatment of retail exposures should be more granular and risk sensitive. .......... 81

D. The definition of high volatility commercial real estate should be narrowed in certain respects. .......... 81

E. The Standardized Approach NPR's treatment of past due exposures should conform to Basel II, both by defining past due exposures as net of specific provisions and applying Basel II's graduated risk weighting. .......... 83

F. The 100% credit conversion factor assigned to exposures that, under the Standardized Approach NPR, would be deemed to be "Credit-enhancing representations and warranties" due to the elimination of the current general risk-based capital rules' exception for early-default and premium refund clauses is not justified and should be lowered to more properly reflect the actual risk posed by these exposures. .......... 84

G. All banks should be permitted, subject to regulatory approval, to use IMM for calculating exposure amounts for OTC derivatives, eligible margin loans, repo-style transactions and cleared transactions as a way to enhance the risk sensitivity of capital requirements for all banks. .......... 86

H. The Agencies should permit the use of supervisory-approved simplified VaR methodologies to calculate exposure amounts for repo-style transactions and eligible margin loans for purposes of the Standardized Approach. .......... 88

I. The Proposed Rules should be modified to ameliorate the negative effects of the interaction between the equity exposure rules and the SSFA, particularly in the bank-owned life insurance ("BOLI") context. .......... 89

J. The Agencies should apply the same 20% risk weight to securities firms that would apply to banks. At a minimum, the risk weight should be much lower than 100%. .......... 90

K. The existing 50% risk weight ceiling on OTC derivative contracts should be retained. .......... 91

L. Standard supervisory haircuts should be harmonized with international rules and supported by actual price volatility experience. .......... 91

M. We are supportive of the Agencies' re-examining risk weights for certain revenue obligation municipal exposures. .......... 92

V. Advanced Approaches NPR .......... 93

A. The Advanced Approaches NPR uses extraordinarily narrow triggers for events giving rise to an increased minimum holding period or margin period of risk for certain netting sets and should be revised, including via the incorporation of a materiality standard. .......... 93

B. The Advanced Approaches NPR's provision implementing Basel III's increased asset value correlation factor for exposures to credit institutions should conform to Basel III and apply a 0.12 factor to *e* instead of the 0.18 factor set forth in Section 131(e) of the Proposed Rules. .......... 95

C. An Advanced Approaches bank that falls below the $250 billion consolidated total assets or $10 billion foreign exposures threshold, as applicable, should no longer be subject to the Advanced Approaches. .......... 96

D. The Advanced Approaches NPR's elimination of the existing 7% risk weighting for equity exposures to money market funds will result in a punitive risk weighting for bank exposures to these funds unless the new rules are modified to accommodate the unique circumstances of these funds. .......... 97

E. OTC derivatives with central banks, multilateral development banks ("MDBs") and other similar entities should be excluded from the capital requirement for credit valuation adjustments (the "CVA capital requirement"). .......... 99

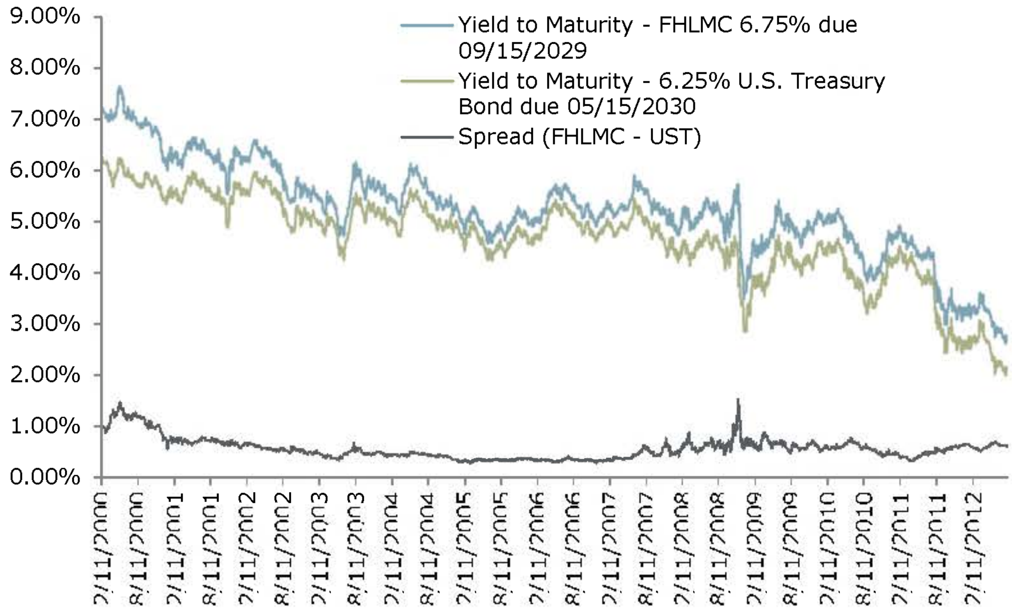
F. Added flexibility should be provided in the determination of credit spread factors for purposes of the CVA VaR calculation. .......... 100

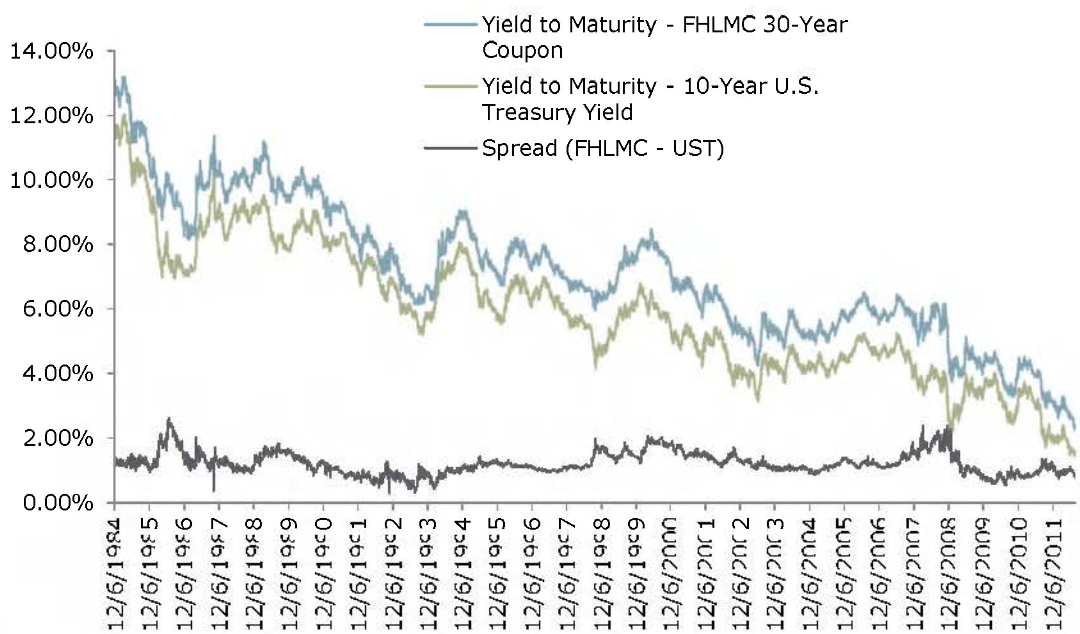
G. Banks should have greater flexibility in the determination of $LGD_{MKT}$. .......... 101

H. For purposes of the shortcut method to capture the effect of a collateral agreement, maturity should equal the notional weighted average maturity ("WAM") of all transactions in the netting set, rather than the greater of the notional WAM and the maximum of half of the longest maturity occurring in the netting set. .......... 101

The following graphs show the correlations during the periods indicated below between the yields of U.S. Treasury securities and Fannie Mae and Freddie Mac debt securities.

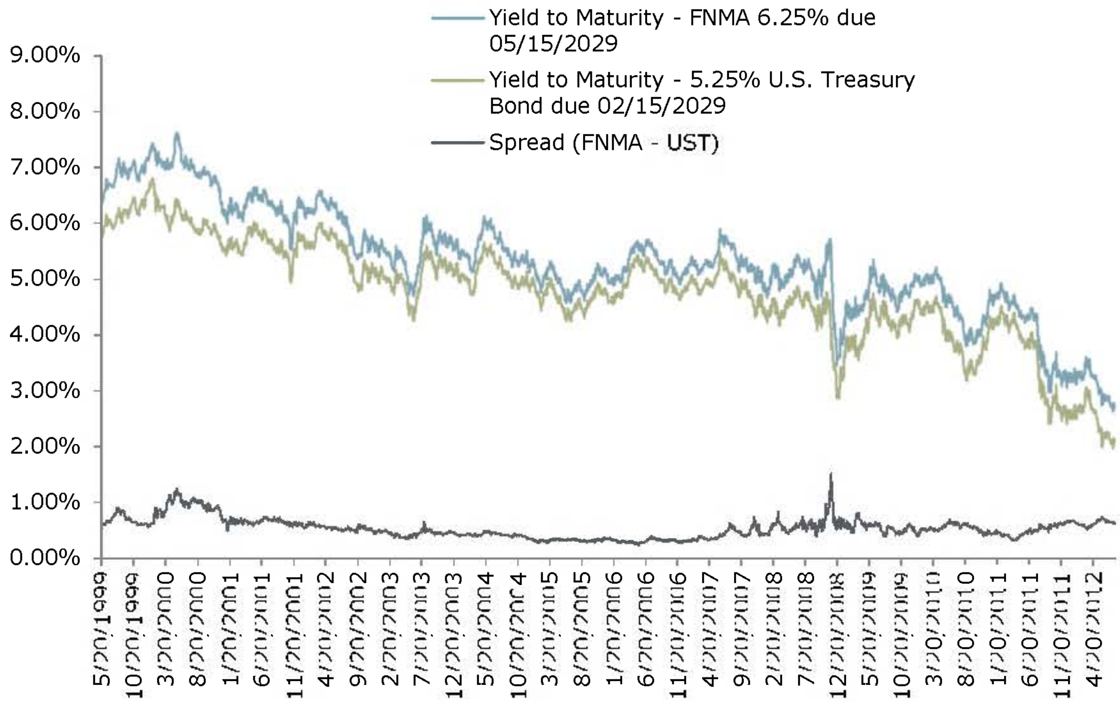
**Freddie Mac Debt Security with a 30-Year Coupon**[186]

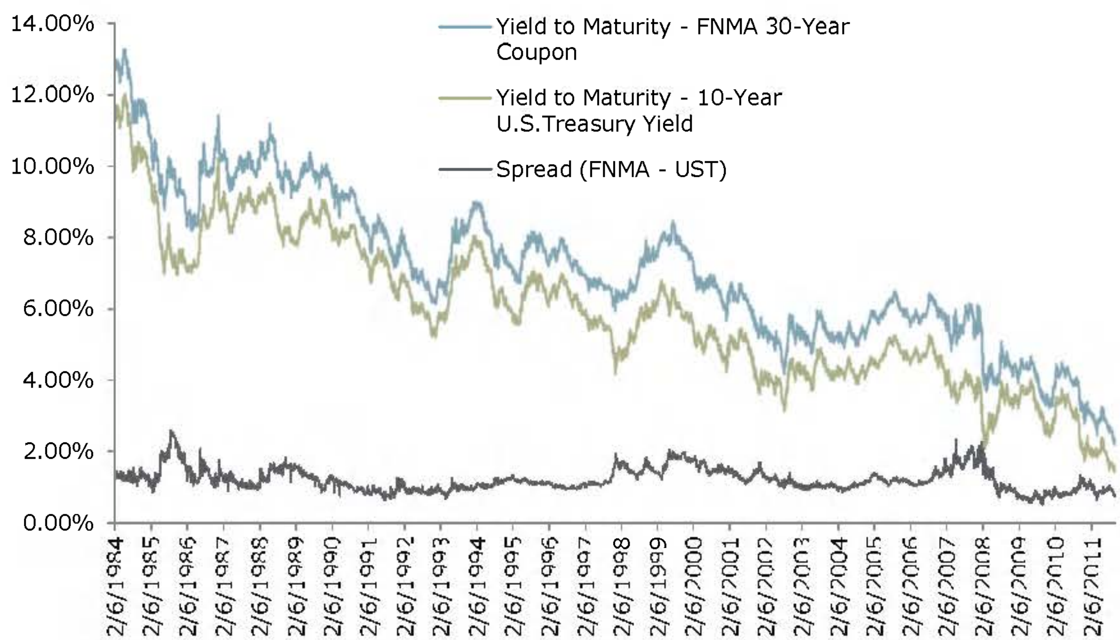



[186] Source: Bloomberg.

## Fannie Mae Debt Security with a 30-Year Coupon [187]

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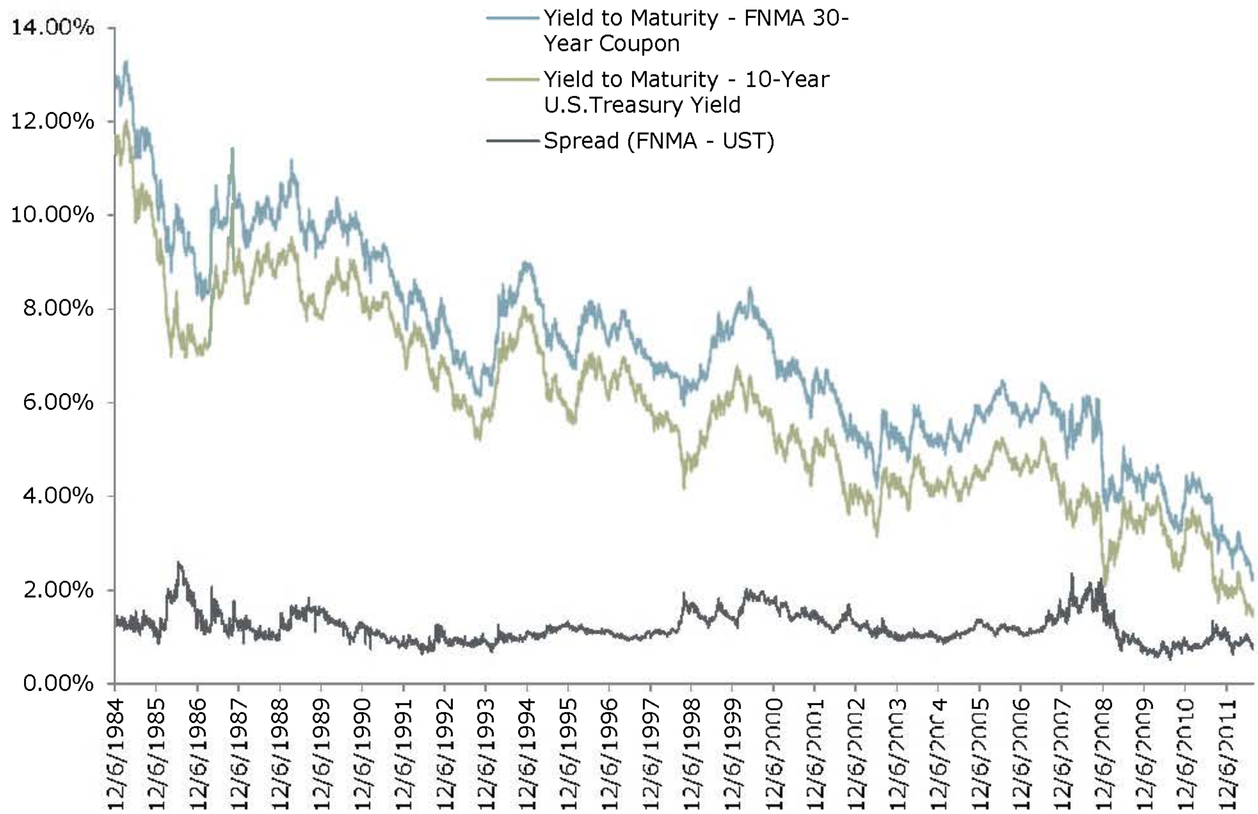
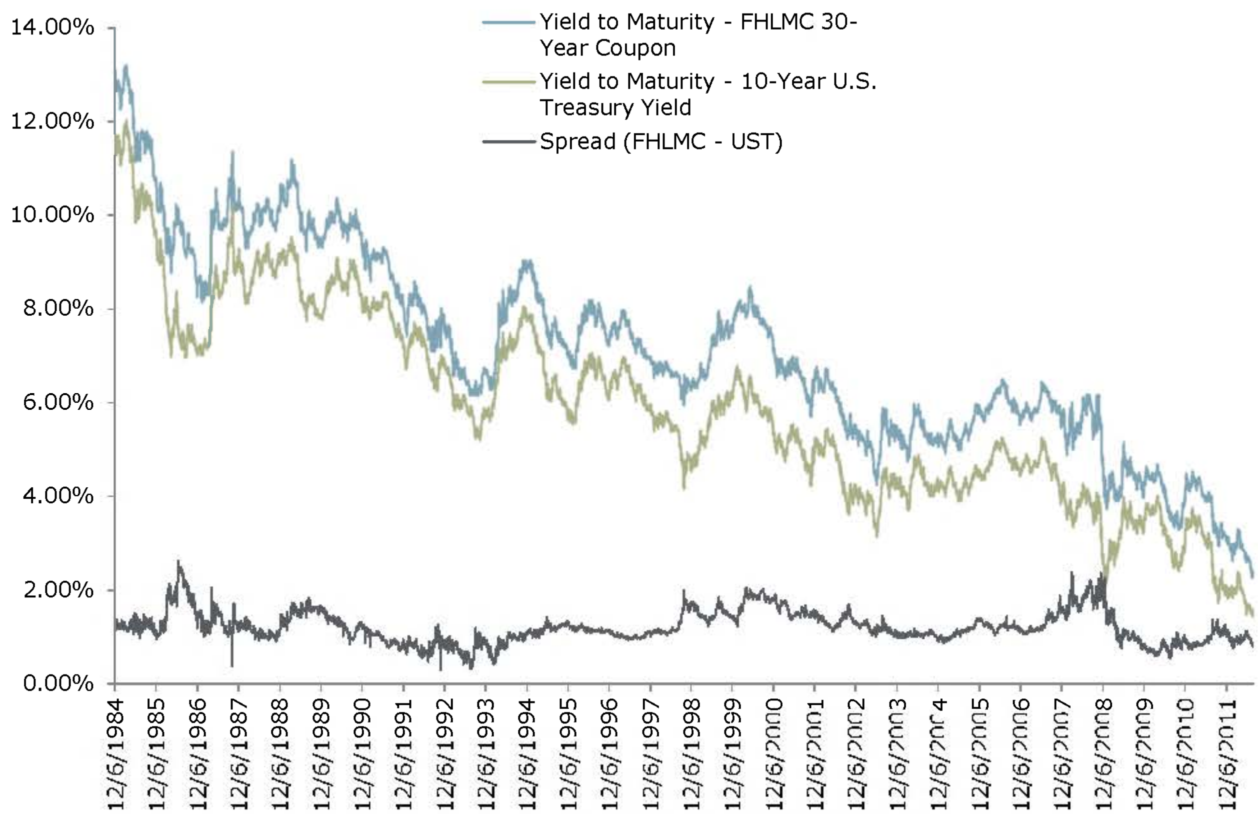
[187] Source: Bloomberg.

## FNMA MBS 30-Year Coupons and 10-Year U.S. Treasury Yields[188]



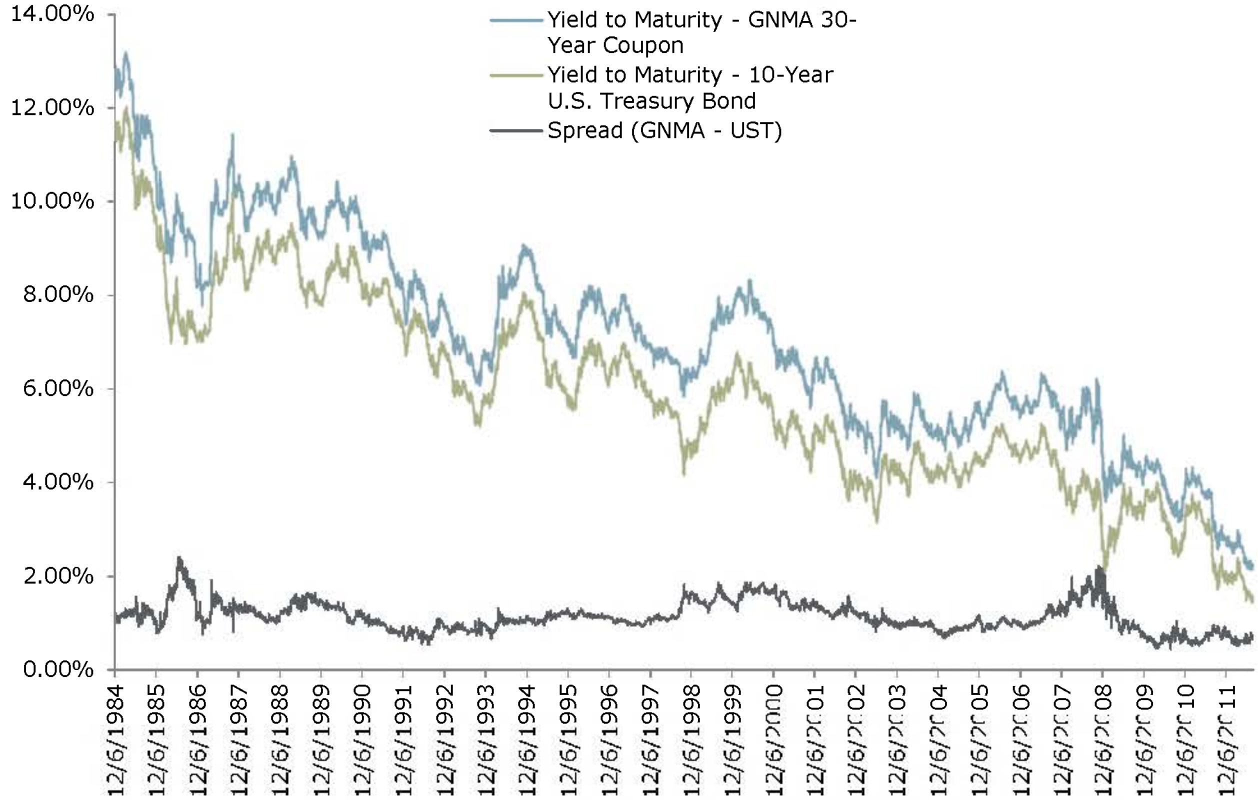

188 Source: Bloomberg.

**FHLMC MBS 30-Year Coupons and 10-Year U.S. Treasury Yields**[189]




[189] Source: Bloomberg.

## Correlation of GNMA MBS Coupons with U.S. Treasuries[190]

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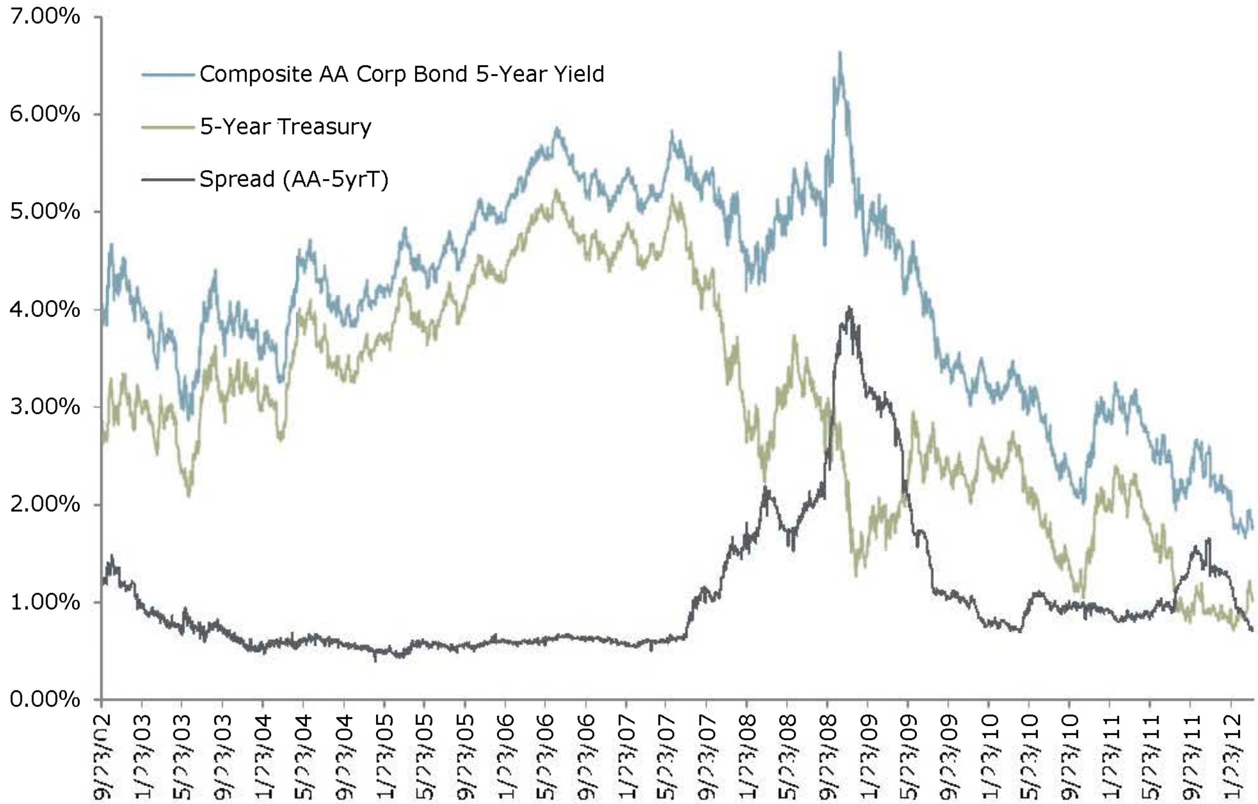
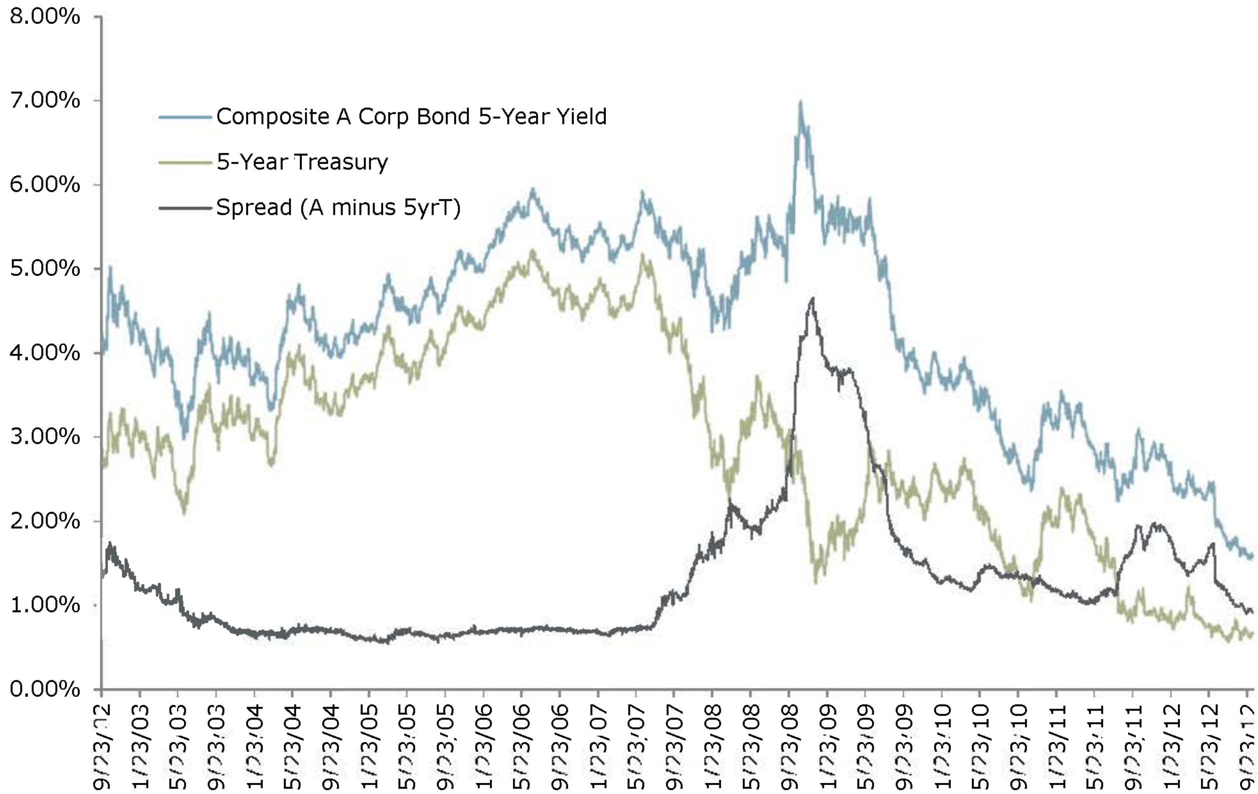
190 Source: Bloomberg.

## AA Composite 5-Year Corporate Bond Yields with U.S. Treasuries[191]



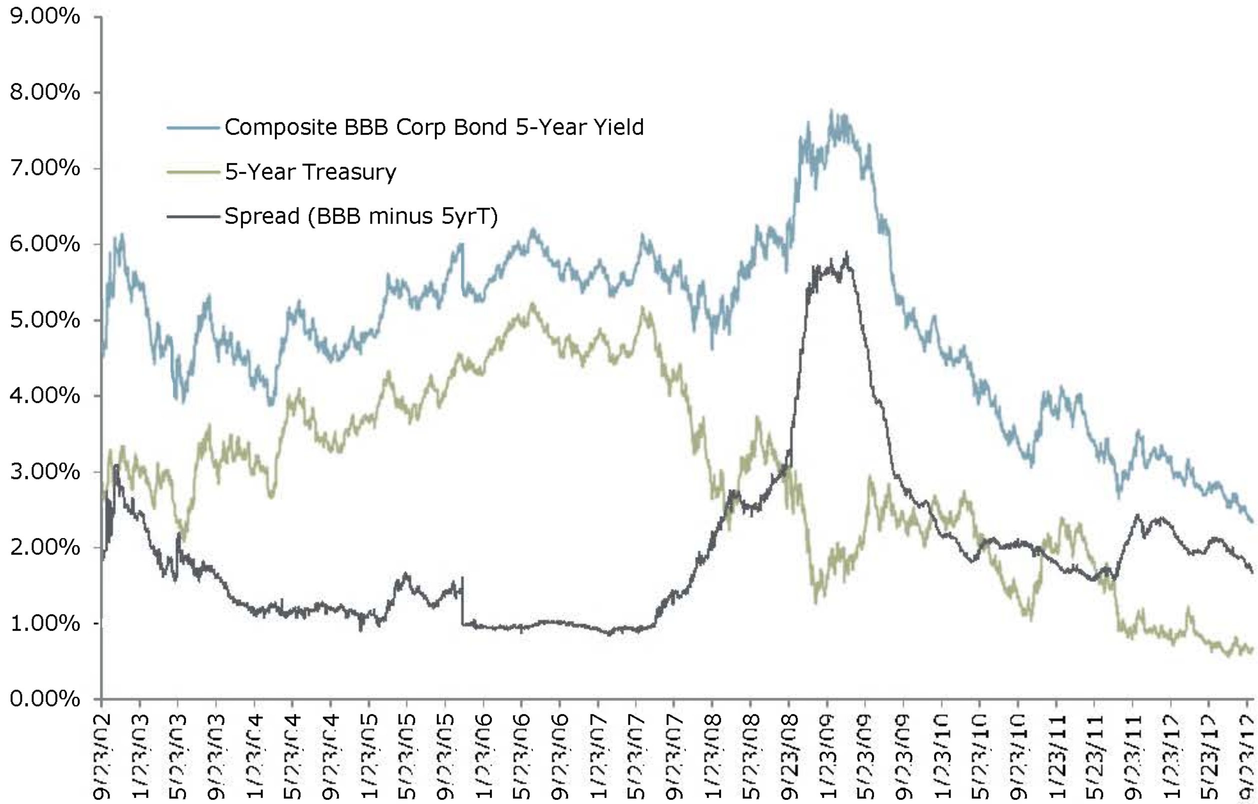

191 Source: Bloomberg.

## Correlation of A Composite Corporate Bond Yields with U.S. Treasuries[192]




192 Source: Bloomberg.

## Correlation of BBB Composite Corporate Bond Yields with U.S. Treasuries[193]




193 Source: Bloomberg.