



BNY MELLON

Gerald L. Hassell
Chairman, President and Chief Executive Officer

June 28, 2012

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve
System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

The Honorable Timothy F. Geithner
Secretary
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

The Honorable Martin J. Gruenberg
Acting Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

BY MAIL AND E-MAIL

Re: Treatment of Unrealized Gains and Losses Under the Basel III Capital Framework

Gentlemen:

As the United States begins implementing the Basel III Accord, I am writing to share BNY Mellon's views regarding the Basel III capital framework's removal of the existing filter of unrealized gains and losses on financial instruments (the "AOCI filter") from regulatory capital. We will reiterate these concerns through the formal comment process in the coming weeks as well.

There is little doubt that during the financial crisis regulatory capital levels overstated the loss-absorbent capital held by banks, partly due to the fact that valuation changes went unrecognized. The result was a loss of confidence by investors, counterparties, and the public in banks' stated capital levels. BNY Mellon supports requiring higher quality and quantities of capital to ensure investor and market participant confidence. However, we believe the complete removal of the AOCI filter will have the opposite effect. Compelling the recognition of unrealized gains and losses solely due to interest rate movements – and not actual changes in credit risk – may lead to investor confusion and regulatory capital arbitrage.

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As you know, on several occasions our senior leadership has discussed our concerns with your agencies. We very much appreciate your engagement on this issue and your continued work towards a more tailored solution. We are concerned that removing the AOCI filter will:

- Overstate capital in low rate environments and understate capital when rates are higher;
- Lead to regulatory capital calculations that inaccurately reflect the risk profile of a firm's balance sheet;
- Compel financial institutions to hold an additional buffer of Tier 1 common equity to manage volatility unrelated to credit risk, which will in turn increase the cost of capital of owning U.S. government securities and other liquid assets;
- Potentially disadvantage U.S. firms because of differing accounting standards abroad; and
- Negatively impact industry risk practices related to asset-liability management by discouraging investments in liquid securities with appropriate interest rate durations.

We worry that removing the filter may encourage some banks to make important risk management decisions based on accounting methodology differences and not liquidity and interest rate management best practices. For example, as explained in the attached Appendix, removing the filter may require a bank to hold more than twice as much capital against a 10-year U.S. Treasury note than a 10-year, fixed-rate, private commercial and industrial ("C&I") loan. This is largely due to a bank instituting a necessary AOCI volatility buffer. Such anomalous results undermine the risk management principles of Basel III, reduce risk sensitivity in capital calculations and will distort systemic and idiosyncratic risk.

Given the inherent volatility that would result from removing the AOCI filter and the potential for unintended consequences, BNY Mellon urges you to retain the filter for higher quality assets, such as U.S. government and agency securities and certain highly rated municipal and foreign sovereign debt.

Should you require further information or have any questions, I would be pleased to discuss BNY Mellon's views on this matter with you or your colleagues.

Sincerely,



Appendix

Estimated Capital Requirements (per \$million)

| | <u>Risk</u> <u>Weight</u> | <u>RWA</u> <u>Based</u> | <u>AOCI 200 bp</u> <u>Interest Rate</u> <u>Volatility</u> <u>Buffer</u> | <u>Total</u> |
|--|------------------------------|----------------------------|--|--------------|
| 10-Year US Treasury | 3% | \$2,400 | \$107,000 | \$109,400 |
| 10-Year Fixed Rate C&I Loan | 51% | \$45,900 | \$0 | \$45,900 |

Assumptions include a capital level of 9% Tier 1 common equity. Regarding 10-year Treasury securities, risk weight is 3% based on Q1 2012 average. We reviewed 1,100 BNY Mellon C&I loans to arrive at the average risk weighting of 51% for Q1 2012.