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September 20, 2012

The Honorable Thomas J. Curry, Comptroller  
Office of the Comptroller of the Currency  
[regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov)  
Docket ID OCC-2012-0008, -0009 & -0010

The Honorable Ben S. Bernanke, Chairman  
Board of Governors of the Federal Reserve System  
[regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov)  
Docket No. 1442

The Honorable Martin J. Gruenberg, Acting Chairman  
Federal Deposit Insurance Corporation  
[comments@FDIC.gov](mailto:comments@FDIC.gov)  
RIN 3064-AD95, -AD96 & -AD97

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 Rules; Market Risk Capital Rule

Heads of the Agencies:

On behalf of Sandler O'Neill + Partners, L.P., we are commenting on the Agencies' three joint notices of proposed rulemaking ("NPRs") to implement agreements reached by the Basel Committee on Banking Supervision in *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems*, December 2010 ("Basel III Accord"), consistent with provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act" or "DFA").<sup>1</sup>

While we have reviewed all three NPRs, this letter focuses on various provisions of two of them, the Basel III NPR and the Standardized Approach NPR. On September 6<sup>th</sup> we submitted a companion letter commenting on a single provision of the Basel III NPR: the proposal to recognize (include) in common equity tier 1 capital unrealized gains and losses on all available-for-sale ("AFS") securities, both debt and equity, pursuant to a phased transition period from calendar

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<sup>1</sup> The three NPRs are together titled *Regulatory Capital Rules* and individually subtitled *Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action* ("Basel III NPR"), 77 FR 52792 (August 30, 2012); *Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements* ("Standardized Approach NPR"), 77 FR 52888 (August 30, 2012); and *Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule* ("Advanced Approaches and Market Risk NPR"), 77 FR 52978 (August 30, 2012). Comments are due October 22, 2012.

years 2013 to 2018. That letter and this letter together constitute our comments on the Agencies' NPRs.

Sandler O'Neill is a market-leading, full-service investment banking firm and broker-dealer focused on the financial services sector.<sup>2</sup> We address the Agencies as a firm of financial professionals who work closely with a wide variety of financial firms nationwide and, increasingly, around the globe. Our clients include almost a thousand banks and thrifts (together, "banks") and their holding companies.

## Overview

This letter has been prepared from the perspective of experienced practitioners in the financial sector at a 25-year-old firm that, with its clients, has navigated several crises and regulatory reforms. The topics covered reflect our review of the NPRs and related aspects of the Dodd-Frank Act, as well as discussions with our banking clients. The eleven sections of this letter cover the following topics:

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Comments are of three types: requests for clarification, requests for a change in implementation to eliminate or reduce unintended adverse consequences, and requests for non-implementation of a rule as unnecessary or counterproductive. Our goal in submitting these comments is to contribute constructively to a rulemaking process that enhances the safety and soundness of U.S. banks without sacrificing efficiency and competitiveness or damaging the U.S. financial system or economy.

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<sup>2</sup> For further information on Sandler O'Neill, see <http://www.sandleroneill.com/>.

## 1. AFS Securities & Cash Flow Hedges

The Basel III NPR proposes to include unrealized gains and losses on available for sale (“AFS”) securities in regulatory capital, while excluding gains and losses on cash flow hedges unless the hedged item is carried at fair value. In summary, we note that if implemented, these two proposals

- are fundamentally flawed in their conception
- will create volatility in regulatory capital due to normal market fluctuations
- will place material pressure on regulatory capital in a rising rate environment
- will reduce rather than improve the safety and soundness of the banking system
- will increase systemic risk to the U.S. economy and several capital markets

We find it particularly helpful and critically important to recognize that banks have three sets of tools to manage interest rate risk. Banks apply the first set to the asset side of the balance sheet, the second to the liability side, and the third set consists of off-balance-sheet hedging derivatives. Therefore, the consideration of symmetrical treatment should govern the capital recognition of gains and losses to avoid unintended consequences.

### Capital Recognition of AFS Gains & Losses

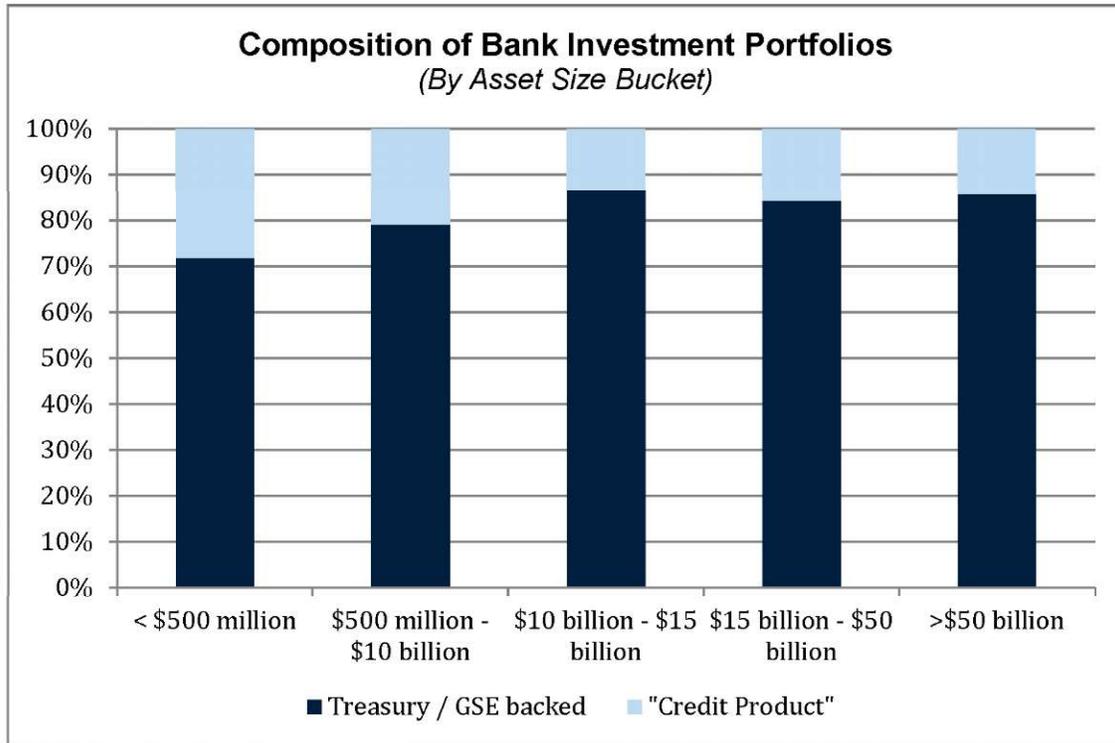
In our companion letter, we have argued in more depth and detail that the proposed inclusion of fair value changes in the calculation of regulatory capital reflects bad accounting that the Agencies should not propagate in their capital rules.

We understand that the proposed treatment of AFS securities reflects an attempt to accelerate the recognition of potential credit-related losses in regulatory capital. As we have noted in our companion letter, the joint development of an expected loss approach to the recognition of other-than-temporary impairment (“OTTI”) of securities and loans by the Financial Accounting Standards Board (“FASB”) and International Accounting Standards Board (“IASB”) substantively addresses this perceived problem for both U.S. and foreign banks.

Moreover, for U.S. banks in particular the proposed capital recognition would largely reflect temporary impairments caused by the fluctuation of market interest rates rather than credit impairments because on average some two-thirds of the securities portfolios of U.S. banks consists of instruments issued by the U.S. government and its agencies and government sponsored enterprises (“GSEs”), whose market value reflects market interest rate levels rather than credit spreads (Exhibit A below).

On the other hand, if the supervisory purpose were to capture interest rate risk in capital, the proposed inclusion of unrealized AFS gains and losses is ill suited because it is so incomplete. On average, U.S. banks hold only 23% of their assets in their securities portfolios, which means that the interest rate risk attributable to over three-fourths of their assets and all of their liabilities would not be reflected in capital. U.S. banks manage interest rate risk on an enterprise basis, and requiring them to reflect in capital the interest rate risk inherent in less than one-quarter of their assets would disrupt sound risk management practices that banks have developed over decades with the encouragement of the Agencies.

Exhibit A



Source: SNL Financial

### Capital Recognition of Cash Flow Hedges

The rationale underlying paragraphs 71 and 72 of the Basel III Accord for the capital recognition of gains and losses on cash flow hedges seriously confuses cash flow and fair value hedge accounting. Fair value hedging focuses primarily on equity volatility and thus provides for the symmetrical treatment of gains and losses on both the hedge and the item whose value is being hedged, with both flowing through earnings. Cash flow hedging focuses primarily on earnings volatility and hedges forecasted future transactions, many of which aren't on the balance sheet at all. (Typical examples of U.S. bank use of cash flow hedging include fixing or capping floating rate or short term debt, or locking in the cost of forecasted future debt issuance.) The very concept of recording the hedged item at fair value is inapplicable, since the fair value of the forecasted cash flows is not affected by changes in market rates due to their variable nature, or because they will occur in the future at then-market rates. Thus, the perceived asymmetry cited in paragraph 72 as the reason for derecognizing these gains and losses in capital does not actually exist under current U.S. capital treatment. In fact, the Agencies' proposed treatment of unrealized gains and losses on AFS securities and certain cash flow hedges (such as hedges of short term debt or forecasted liability issuance), viewed in combination, create the very asymmetry that the Basel III Accord seeks to avoid.

### **Market-Driven Regulatory Capital**

Our companion letter explores in detail the negative impact on regulatory capital that a higher interest rate environment would have due to temporary changes in the market value of AFS securities. We note further here our concern that this sharp decline in regulatory capital is likely to occur precisely at the time when the counter-cyclical capital buffer requirement of Basel III could increase the amount of required capital.

Even in the absence of a directional trend in rates, recent experience illustrates how disruptive to sound risk management artificially volatile capital ratios could be if the market interest rates driving them fluctuate wildly from quarter to quarter. On June 30, 2010, the yield on 5-year U.S. Treasuries, a useful interest rate benchmark when modeling bank investment portfolios, was at 1.79%, and one year later it was virtually unchanged at 1.75%. However, over the year that yield was volatile, with a quarter-end low of 1.03% and a high of 2.34%.

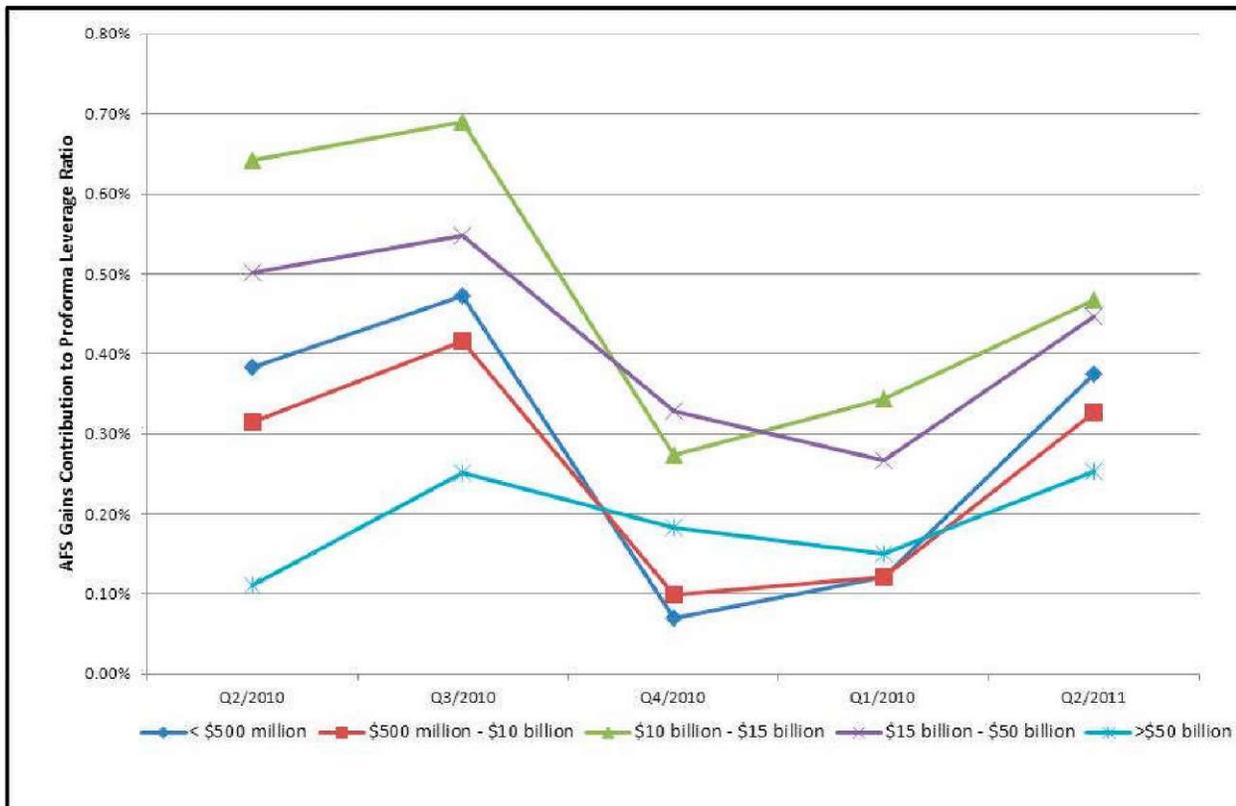
Exhibits B and C below show the impact of that volatility on the market value of AFS securities and pro-forma Basel III leverage ratios for U.S. banks,<sup>3</sup> demonstrating that during a period when Treasury interest rates started and ended at the same level, bank capital ratios would have shown nearly a 40 basis point swing from high to low, with community banks, which have the most limited access to capital, impacted more than most. This is no isolated market event – in the last twenty years there have been eight four-quarter periods of high interest rate volatility despite rates ending roughly where they began, with rate fluctuations during that period as high as nearly 150 basis points from low to high. Such volatility would make it inordinately challenging for banks to manage their regulatory capital and their balance sheets.

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<sup>3</sup> Study includes almost 6,000 banks for which reliable data on AFS securities is available.

**Exhibit B**

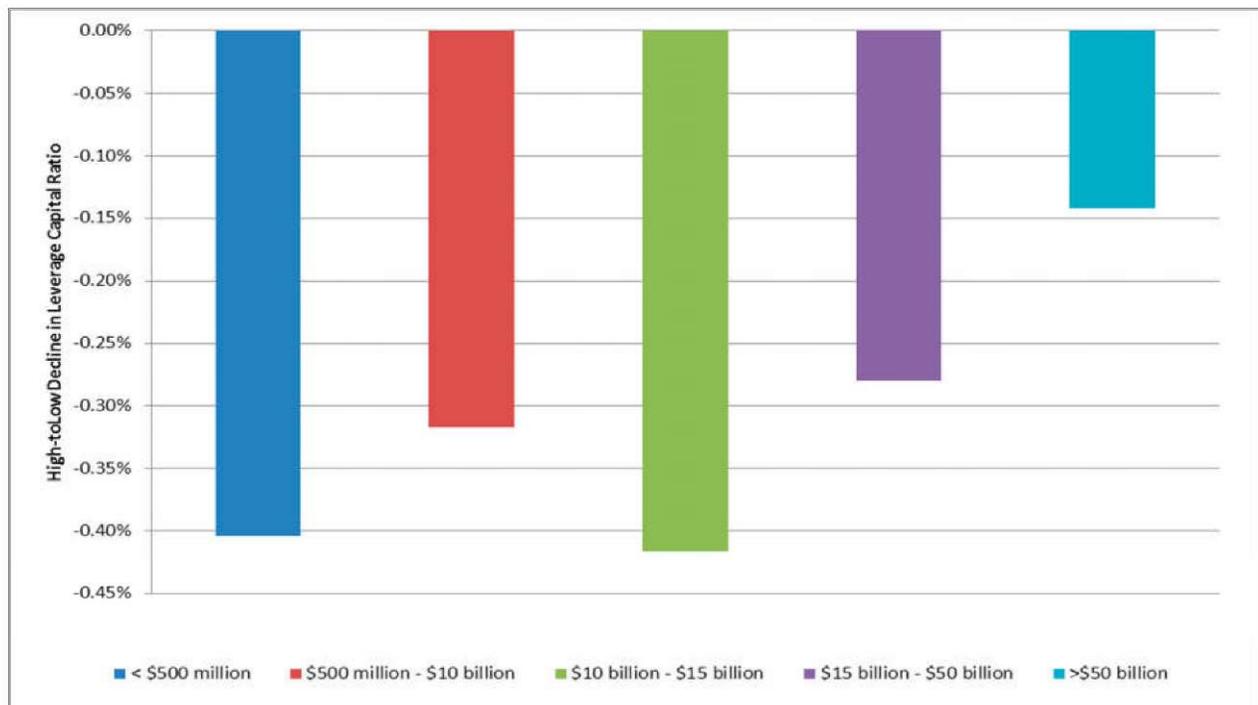
**AFS Gains Contribution to Leverage Capital Under Basel III**  
**Q2/10 to Q2/11**  
*(By Asset Size Bucket)*



Source: SNL Financial

Exhibit C

**Intra-Year Decline in Leverage Capital Under Basel III (From High to Low)  
Q2/10 to Q2/11  
(By Asset Size Bucket)**



Source: SNL Financial

**Erosion of Safety and Soundness**

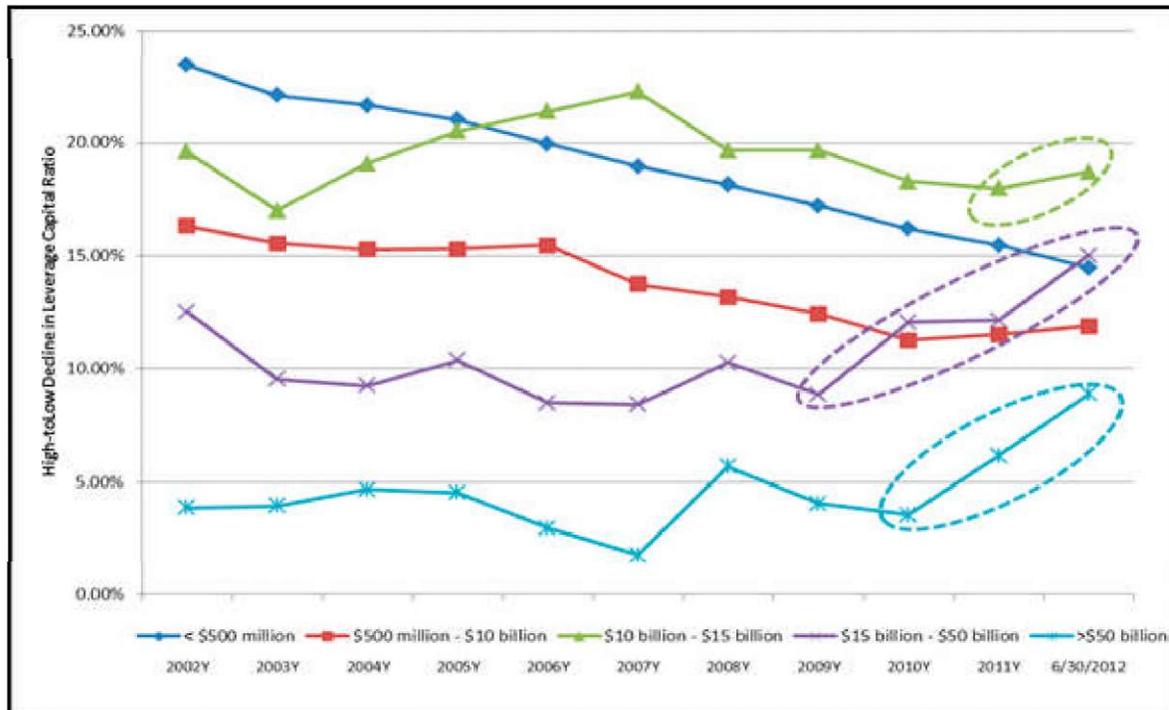
If implemented as proposed, these provisions would create incentives, some of them perverse, driven by the management of regulatory risk rather than risks management should be focused on, such as the enterprise-wide balancing of interest-rate and credit risk. Banks would be pressured to:

- *Shorten the duration of their investment portfolios* to reduce price volatility at the expense of earnings, impairing long-term capital formation.
- *Enlarge held-to-maturity (“HTM”) portfolios* to avoid price volatility at the expense of balance sheet flexibility and interest rate risk management.<sup>4</sup> This is already occurring at larger banks, which have had a head start in addressing Basel III, as shown in Exhibit D below.
- *Substitute credit risk for duration risk* to maintain yields regardless of other prudential considerations.

<sup>4</sup> Although the Basel III Liquidity Accord provides that Level 1 assets are “held at market value,” our understanding is that the intent is not to exclude HTM securities from Level 1 liquid assets. Basel Committee on Banking Supervision, *Basel III: International Framework for Liquidity Risk Management, Standards and Monitoring*, December 2010, paragraph 39. Specifically, market value of HTM securities will be used for liquidity calculations but will not affect book value.

**Exhibit D**

**% of Securities Classified HTM**  
(By Asset Size Bucket)



Source: SNL Financial

**Increased Economic and Market Risk**

If implemented as proposed, these provisions would introduce systemic risk to the U.S. economy and markets in several ways. Banks will need to hold capital against potential securities price volatility, leaving less capital to support lending. In addition, a pullback from investing in longer duration MBS, agency debt, and municipals, of which over \$2 trillion are held at U.S. banks, could drive mortgage rates higher and weaken the financial condition of GSEs and municipalities by increasing their funding costs.

## Recommendation

Given the ill-conceived basis of these provisions and their overwhelmingly negative consequences, the most prudent course of action for the Agencies is to avoid any temporary volatility in regulatory capital by excluding all unrealized gains and losses currently recognized in AOCI but not in regulatory capital. Failure to do so not only propagates the impact of bad accounting on the measurement of regulatory capital, but also will seriously hamper banks' ability to manage interest rate risk on both sides of the balance sheet.

Proposed tweaks to these provisions, such as the outright exemption of gains and losses on U.S. government and GSE securities, or the bifurcation and exemption of interest-rate-related losses from all securities, would blunt the negative impact but still do damage. We particularly note that any piecemeal approach to picking temporary gains and losses to include in regulatory capital ignores the interconnectivity of sound asset-liability management strategies, and will create perverse incentives for banks to increase other risks in order to avoid capital volatility while maintaining earnings. While half measures would be better than none, all roads lead back to the only prudent solution, which is to symmetrically exclude all unrealized gains and losses from regulatory capital.

## Important Technical Clarification

Consistent with the Basel III Accord, the Agencies generally propose to include accumulated other comprehensive income (AOCI) in common equity tier 1 capital.<sup>5</sup> They specifically propose that "unrealized gains and losses on all AFS securities would flow through to common equity tier 1 capital."<sup>6</sup>

We note, however, that under U.S. GAAP, amounts of impairment attributable to causes other than credit losses for both AFS and HTM securities are recognized in other comprehensive income (OCI) outside of earnings, and hence in AOCI.<sup>7</sup> Thus, in the absence of clarification, the Basel III NPR could be read to propose that unrealized gains and losses on both AFS and HTM securities be included in common equity tier 1 capital.

We believe that on balance the Basel III NPR should be read to propose that unrealized gains and losses on AFS securities only be included in regulatory capital. Regardless of how the Agencies resolve the inclusion in capital of unrealized gains and losses on AFS securities, we believe it important for them to confirm that they did not intend to suggest that such losses on HTM securities also be recognized in regulatory capital.

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<sup>55</sup> Basel III NPR, 77 FR at 52810, reflecting the Basel III Accord provision that "[t]here is no adjustment applied to remove from Common Equity Tier 1 unrealised gains or losses recognised on the balance sheet." Basel III Accord, ¶ 52 at p. 13 & n. 10.

<sup>6</sup> Basel III NPR, 77 FR at 52811.

<sup>7</sup> FASB Staff Position No. FAS 115-2 & FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments*, April 9, 2009.

## 2. Residential Mortgage Market

The U.S. residential mortgage market has been very slow to recover from the economic downturn beginning in 2007. Clearly, the health of this sector of the economy will be important to sustain a broad economic recovery, yet there are at least three Basel III requirements and one Dodd-Frank requirement that will retard the recovery in the residential mortgage market. These requirements include

- the add-back of mortgage loans sold to the U.S. agencies with certain “credit enhancing” representations and warranties,
- the increase in risk weighting associated with mortgages with higher LTVs or loans that qualify as Category 2 loans,
- the deduction of investment in mortgage servicing rights (“MSRs”) above threshold levels, and
- the Dodd-Frank requirement of a 5% retained interest in the securitization of non-qualified mortgage assets.

There may be merit in the individual requirements proposed to bolster the safety and soundness of the U.S. mortgage market, but taken together these four factors could materially impair the business model for creating residential mortgage credit in the U.S., resulting in increased cost to the consumer and/or limited access to funding.

*First*, under the general risk based capital rules, a banking organization is subject to a risk-based capital requirement when it provides credit-enhancing representations and warranties on assets sold or otherwise transferred to third parties because such positions are considered recourse arrangements. But these recourse rules exclude early payment default clauses, premium refund clauses that cover U.S. government or agency guaranteed assets, and warranties that permit the return of the asset due to fraud, misrepresentation, or incomplete documentation.

<u>Representation or Warranty</u>	<u>Current</u>	<u>Basel III</u>
Early Payment Default	Excluded	Included
Premium Refund Clauses	Excluded	Included
Fraud, Misrepresentation or Inc. Docs.	Excluded	Unclear

However, the Agencies appear to be proposing that in cases where credit enhancing representations and warranties are provided on assets sold (or otherwise transferred to third parties) with early default clauses or premium refund clauses, a banking organization would treat this arrangement as an off-balance sheet guarantee with a 100% credit conversion factor (“CCF”) applied to the exposure amount.<sup>8</sup> The NPR wording is silent on whether warranties that permit the return of assets in the instances of fraud, misrepresentation, or incomplete documentation would be considered off-balance-sheet guarantees with 100% CCF, an issue that should be clarified. The

<sup>8</sup> Standardized Approach NPR, 77 FR at 52902.

NPR wording is also silent on whether the CCF would be removed at the time of expiration of a representation or warranty, although it is logical to assume so.

To put this proposed change in perspective, in 2011 approximately \$1.3 trillion in single-family residential loans were originated in the U.S., of which over \$600 billion were sold to the U.S. Government or its agencies.<sup>9</sup> Assuming that these loans all included credit enhancing representations and warranties with a 100% CCF and 50% asset risk weighting, an additional \$300 billion of risk weighted assets would be added to the originating banks. To maintain a 7% common equity tier 1 (“CET1”) capital ratio, these banks would collectively need to raise an additional \$21 billion of tangible common equity or forego roughly \$300 billion in additional lending opportunities for 50% risk-weighted assets. Alternatively, if the CCF applies only during an assumed warranty period of 120 days, the amount of equity that the originating banks would need to raise would approximate \$7 billion (\$21 billion x 120/365).

To address these concerns with “credit enhancing” representations and warranties we offer the following comments.

- Consistent with current practice, we recommend that boilerplate representations and warranties explicitly required by the government agencies should be excluded from the definition of “credit enhancing.”
- If not excluded, we recommend that “credit enhancing” representations and warranties should only be included after the implementation of the final Basel III rules expected to be on or about January 1, 2013.
- We also request that the agencies clarify that the CCF only remains in place for the applicable rep and warranty period rather than the life of the loan as the current NPR wording indicates “there is no grace period, such as the 120-day exception under the current general risk-based capital rules.”<sup>10</sup>

The retroactive application to existing mortgages sold with agency-required representations and warranties could have a chilling effect on the agency mortgage banking market, even if it applies only during a warranty period of 120 days, due to the additional capital required to support mortgage banking activity. No doubt the Agencies have recognized the importance of this issue and invited comment in Question #10 of the Standardized Approach NPR Question #10.<sup>11</sup>

**Second**, the Standardized Approach NPR introduces higher risk weights for residential mortgage loans reflecting the borrower credit profile based on various criteria that could cause a loan not to be characterized as a Category 1 loan. These factors include term, payment frequency, credit underwriting, maximum annual rate variance, HELOCs underwritten to maximum contractual exposure, payment status of less than 90 days past due, and single banking organization holders of senior and junior lien mortgages with combined LTV ratios below threshold levels.

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<sup>9</sup> Source: FNMA, FHLMC, FHFA, Mortgage Bankers Association.

<sup>10</sup> Standardized Approach NPR, 77 FR at 52939.

<sup>11</sup> Standardized Approach NPR, 77 FR at 52902.

We applaud the regulatory move away from applying the same risk weighting to loans regardless of credit profile, but we are concerned that under the proposed methodology, a single loan criterion could trigger an unnecessary Category 2 characterization even though the overall credit profile is clearly very high quality and worthy of Category 1 risk weighting. This single factor vs. basket approach to the characterization of Category 1 or Category 2 loans may result in many unintended consequences. For example, a high LTV loan whose borrower has a very low debt-to-income ratio and/or a high net worth would be evaluated as a Category 2 loan with a much higher risk weighting. Alternatively, a very low LTV loan whose borrower has a higher debt to income ratio would not be similarly disadvantaged. While there is no doubt that excesses in the residential mortgage market contributed to the financial downturn in 2007, a risk-weighting framework that is single-factor focused without regard to the overall profile will contribute to the delay in the recovery of our residential mortgage market.

Based on the number of questions we have received from our bank clients, there is confusion regarding how to calculate the combined LTV ratio for total residential mortgage exposures including unfunded home equity lines of credit. Our understanding is that banking organizations are required to add the first and second lien (or home equity loan exposures fully drawn) in order to calculate a combined LTV. Funded home equity loans are subject to risk weighting dependent upon whether the total exposure (including first lien and second liens) is held by the same financial institution and is considered a Category 1 or Category 2 loan. The determination of Category 1 or 2 is a function of many factors, including combined LTV assuming the unfunded amount is fully drawn.

Unfunded home equity loans are off-balance sheet commitments and therefore a CCF would apply for calculation of risk weighting. For the unused portion of commitments, the CCF varies, depending on the term and whether or not the commitment is "unconditionally cancelable." For financial standby letters of credit, the CCF is 100% regardless of term. For commitments that are unconditionally cancelable, the CCF is zero, so there is no risk weighting for these commitments. For commitments that are not unconditionally cancelable with a maturity of within one year, the CCF is 20%. For commitments that are not unconditionally cancelable with a maturity of greater than one year, the CCF is 50%. For example, a Category 2 residential loan with an LTV greater than 90% has a risk weighting of 200%. The CCF of 50% is multiplied by the 200% risk weighting to determine the risk weighting of the unused notional amount. The resulting risk weighting is 100% for the unused notional amount.

The total amount of risk weighted assets for a residential mortgage loan would therefore be the sum of the risk weighted assets associated with the funded amount and the risk weighted assets associated with the unfunded amount (applying the CCF to the risk-weighted asset percentage determined by the Category 1 or 2 status of the exposures).

Because of the complexity of these calculations, we recommend that a series of examples be provided for various scenarios to clarify supervisory intent.

While there is a phase-in of these risk-weighting rules, Category 2 residential mortgage exposures are effectively less valuable than an equivalently yielding Category 1 exposure due to the higher risk weighting and allocated capital. We believe the market did not anticipate the increase in risk weighting resulting from the characterization of certain mortgage exposures and the elimination of private mortgage insurance (“PMI”), and that it would be inappropriate for the imposition of these selected underwriting rules and regulations to result in a decline in the fair market value of assets previously originated under accepted industry practice. The imposition of the higher risk weighting on a retroactive basis to all loans outstanding could cause the devaluation of existing residential mortgage portfolios and a substantial increase in risk-based capital requirements for banks involved in residential mortgage lending. While some of these criteria can be measured objectively, other factors – such as documentation and income verification – are a matter of degree, and the specific requirement must be delineated to avoid uncertainty.

For these reasons, we make the following recommendations with respect to risk weighting:

- Changes to risk weighting should be applied on a prospective basis as new loans are originated after January 1, 2013. If existing loans are not grandfathered, the lender would have the invidious choice of selling newly depreciated loans or holding additional capital to support them. Unregulated banking organizations would face no such requirement for higher capital, and mortgage banking activity could further migrate to the shadow banking market.
- A methodology for overall credit profile should be developed that takes into account a cumulative view of the credit factors rather than rely on a single factor for determining risk weighting. This profile should also recognize high quality and properly underwritten PMI in the determination of the LTV ratio for residential mortgage exposures. To do otherwise would severely limit the flexibility of lenders to respond to demand for residential credit in a responsible and pragmatic way.
- The calculations of combined LTVs and risk weighting using a variety of first and second lien loans and various commitment types should be clarified.
- The measurement of documentation and income verification used for making a Category 1 determination should be clarified.

**Third**, a critical component of the residential mortgage banking business model is the value of the MSR<sub>s</sub> created at the time of loan origination. Deduction of MSR<sub>s</sub> above 10% CET1 capital after adjustments means that servicing will become less attractive as a bank asset and more likely move to nonbank investors that require higher unleveraged returns on investment. MSR<sub>s</sub> have historically been valued at a multiple of 2 to 4 times the annual servicing fees of about 25 to 50 basis points per loan, or roughly 0.50% to 2.0% of the value of a typical agency eligible loan. If banking organizations were forced to sell these assets due to their deduction from CET1, then such organizations would be compelled to charge higher origination fees or coupons in order to maintain similar levels of profitability.

To the extent that such organizations are not able to pass along price increases to consumers in the market, this would result in reduced availability of mortgages and reduced profitability for the banking organizations. To lessen the impact of this Basel III MSR deduction on the U.S. residential mortgage market, we offer three recommendations:

- Grandfather all existing MSRs that are already being fair valued on bank balance sheets.
- Increase the permitted amount of MSRs to 15% of CET1.
- Exclude MSRs from the current 15% aggregate basket that applies to deferred tax assets, MSRs, and significant investments in unconsolidated financial entities.

These steps would lessen the impact of the MSR deduction. If these actions are not taken, the market for investment in MSRs will likely continue to shift from banking organizations to non-bank investors that do not face the deduction of MSRs from capital.

**Fourth**, the residential mortgage market would also be damaged by the proposed requirement that securitizers of non-qualified, non-agency residential mortgages (non-QRM) retain a 5% interest in such securitization, pursuant to section 941 of the Dodd-Frank Act. While there are a number of alternative ways that this interest can be structured, it has the impact of effectively raising the cost of securitization and, in so doing, reducing the formation of credit and the value of assets to be securitized. A study last year foreshadowed this concern by noting “if risk retention requirements are too stringent, they could constrain lending, and consequently, the formation of credit.”<sup>12</sup> We note that some industry studies have estimated that the impact on spreads of qualified residential mortgages compared to non-qualified residential mortgages could be between 80 and 185 basis points per loan.<sup>13</sup> In other words, this 5% retained interest requirement could result in a reduction in value of residential mortgage loans that have been previously originated that would not meet the QRM rules and are held for sale.

We note that the final QRM rules are yet to be adopted and hope that these rules would be applied to new originations rather than currently outstanding loans. Secretary Geithner’s report calls for “regulators to take into account the changing nature of markets and future innovations and whether such rules should be adjusted accordingly” (p. 29). Clearly the U.S. residential real estate market has been slow to recover from the recent crisis, and the higher cost of securitization from this 5% retained interest requirement has been an overhang on the market. We recommend that the Agencies delay the implementation of the 5% retained interest until the U.S. residential market has more fully recovered or provide more flexibility in the definition of qualified vs. non-qualified mortgages to accommodate a greater percentage of residential mortgage originations.

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<sup>12</sup> Timothy F. Geithner, Financial Stability Oversight Council, *Macroeconomic Impact of Risk Retention Requirements* (January 2011), p. 30.

<sup>13</sup> “QRM: Higher Mortgage Rates on the Horizon,” *Economists’ Outlook* (June 2011).

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Overall, if not modified, these four factors would materially depress the financial returns associated with residential mortgage banking activity. While the higher risk-based capital requirements will phase in over time between 2014 and 2018, it would be naïve to think that investors would not take into account these higher required capital levels, resulting in a discount to the asset values (loss) on assets that were previously originated. Along with higher required pricing for new originations, these losses could result in either reduced access to funding and/or increased costs to the consumer. (We note anecdotally that a material number of our bank clients have indicated that they are exploring exiting the residential mortgage lending business, in whole or in part, if these rules are implemented as proposed.) Furthermore, to the extent that banks pull back from their involvement in mortgage lending as a result of these factors, their access to funding from the Federal Home Loan Bank system would be reduced, increasing systemic funding risk in the banking system and straining the FHLB system. We have offered a number of recommendations for clarification, change or delay in implementation of proposed rules relating to the residential mortgage market, and we request that the Agencies give serious consideration to each.

### 3. Non-Reliance on Credit Ratings

Although the Basel III Accord allows G-20 banks to rely on credit ratings to risk weight many assets, consistent with section 939A of the Dodd-Frank Act the Agencies have proposed alternative methodologies for risk weighting certain assets, including residential mortgages, securitization exposures, and counterparty credit risk. These and other methodologies in the Standardized Approach NPR are proposed to take effect January 1, 2015. As a result, U.S. insured depositories face an uneven playing field relative to the G-20 banks.

This inconsistent application of the Basel III capital rules places an additional documentation and reporting burden on U.S. financial institutions, requires the use of sophisticated risk weighting models to assess the risk based capital for securitized investments, and may cause unexpected results in the application of these alternative standards due to imprecisions of the models or untended consequences. This letter focuses on the impact of non-reliance on credit ratings for risk weighting rather than other implications of section 939A unrelated to the Basel III Accord.<sup>14</sup>

Without the ability to rely on credit ratings, banks now face a much more complicated process to determine the risk weighting for investments in non-agency securitized assets. This determination will now be a function of (i) the size and investment activity for a given bank, which will dictate the use of either the Market Risk, Advanced Approaches, or Standardized Approaches risk weighting framework, and (ii) among the majority of banks selecting the Standardized Approach, the selection of either the Simplified Supervisory Formula Approach (“SSFA”) or the Gross-Up Approach as the risk weighting model.

More specifically, banks with trading assets and liabilities greater than \$1 billion or with trading assets and liabilities greater than 10% of assets are subject to the Market Risk capital rules effective January 1, 2013. Banks with assets greater than \$250 billion or on-balance-sheet foreign exposures greater than \$10 billion are subject to the Advanced Approaches Rules effective January 1, 2015, and all other banks are subject to the Standardized Approach for risk weighted assets effective January 1, 2015.

Banks using the Standardized Approach can choose either the SSFA or the Gross-Up Approach to determine the risk weighting for non-agency securitized assets. The Gross-Up Approach applies the collateral risk weighting to the investor’s tranche and the investor’s pro-rata ownership of the tranches that are more senior. The combined direct and indirect risk is defined as the Credit Equivalent Amount. For senior tranches, the risk weighting is equal to the risk weighting of the collateral, but for subordinate tranches the risk weighting increases as subordination increases since the subordinated tranche must carry capital for a portion of the senior tranche as well.

The SSFA is a complicated formula that incorporates subordination, collateral risk weight, and collateral delinquencies. The subordination factor considers the “attachment” point where the

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<sup>14</sup> Section 939A also affects the determination of permissibility and credit quality of investment securities for U.S. depository institutions. See OCC, Final Guidance, *Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment*, 77 FR 35259 (June 13, 2012); FDIC, Final Guidance, *Guidance on Due Diligence Requirements for Savings Associations in Determining Whether a Corporate Debt Security Is Eligible for Investment*, 77 FR 43155 (July 24, 2012). We understand guidance for state-chartered banks is forthcoming.

percentage of collateral that could default before the tranche is impacted and the “detachment” point where the percentage of collateral that would need to default to impact 100% of the tranche. Collateral delinquency increases the collateral capital required by 50% for that portion of the collateral that is delinquent.

Banks are required under the implementation to apply the same method (Gross-Up or SSFA) across *all* securitization positions. We believe it appropriate for the Agencies to provide guidance as to how frequently, and under what rationale, banks would be permitted to change the approach used. In addition, a closer examination of the two approaches shows that the differences are highly dependent on the capital structure of each securitization, and are not trivial. Exhibit E shows the difference between the two methods as applied to a recent securitization transaction. In the exhibit, we note that (a) the two methods resulted in a 680% difference in the risk weight on the Baa2-rated tranche, and (b) the Gross Up method produces illogical results in which the Baa2-rated tranche carries a much higher risk weight than the equity (first loss) tranche supporting it. These idiosyncrasies will result in regulatory arbitrage as banks opt for the methodology that requires the least amount of capital, will result in inconsistent capital treatment of like exposures across financial institutions, and will create a perverse incentive for banks to hold higher risk tranches that may require less capital than the less risky tranches in the securitization.

### Exhibit E

CLO Example				0% Delinquency			20% Delinquency		
		%	Ratings Based Approach	Gross-Up	SSFA	Gross-Up vs SSFA	Gross-Up	SSFA	Gross-Up vs SSFA
Class A	AAA	59.96%	20.0%	100.0%	20%	500.0x	110.0%	20%	550.0x
Class B	Baa2	9.99%	100.0%	700.0%	20%	3,500.0x	770.0%	160%	481.7x
Class C (Eq)	Unrated	<u>30.05%</u> 100.00%	1250.0%	332.8%	499%	66.8x	366.1%	986%	37.1x

Assumptions: Collateral Risk Weight = 100% Non Delinquent; 150% Delinquent

Re-remics and re-securitizations receive additional punitive treatment for SSFA risk weightings by changing the delinquent exposure calibration parameter ( $p$ ) from .50 to 1.50. Because of the significant penalty imposed on re-remic or re-securitization transactions compared to non-re-securitization CLO transactions, it will be important for the regulators to provide clear guidance on the difference between the partial re-securitization exposures (structured finance buckets) in a CLO transaction and the creation of a re-remic or re-securitization transaction. Some industry professionals have discussed scaling the constant term  $p$  in the SSFA methodology based on the percentage of re-securitization/structured finance bucket exposure (between 0.5 and 1.5) or applying a re-securitization/structured finance bucket exposure maximum (possibly 5% allowance) on legacy CLO deals where the constant term  $p$  in the SSFA methodology would be 0.5, with percentages above 5% triggering a 1.5 constant term  $p$  value. It will be important for regulators to

provide clear guidance on the difference between the redirection of cash flows on a pro-rata basis in a CLO transaction and the creation of a re-remic or re-securitization transaction.

Finally, we find the NPR's calculation definition of SSFA to be incomplete and confusing. There are two sections that define the formula and variables required for the SSFA calculation. The first section is found on pages 52919 through 52922 of the Standardized Approach NPR. The second section is on page 52965. The second section includes a detail that is omitted from the first section. Specifically, this detail in the second section is found under section 43 (5)(c)(3), which adds ***“but with the parameter A revised to be set equal to  $K_A$ , for the purpose of this weighted-average calculation.”*** This additional detail has a significant impact on the results of the SSFA calculation.

Additionally, we find this phrase to be somewhat confusing since the substitution of the variable A for  $K_A$  is only applicable when calculating variable “I.” In order to make the description of the SSFA formula clearer, we suggest that “I” be redefined to be the maximum of 0 and  $A - K_A$ , instead of the existing  $A - K_A$ . This will enable the omission of the confusing phrase quoted above as well as allow both sections to be identical.

There are two additional complications from the use of either of the models, but especially the SSFA model, that would lead to risk-based capital requirements far in excess of the actual risk inherent in the position. First, the use of par value to determine the level of subordination, without regard to purchase price and/or carrying value, significantly overstates the true principal risk on securities purchased and/or held at a deep discount, since a discounted basis represents a potentially material amount of additional credit support that is not properly considered in the computation of required capital.

Second, the formulas ignore the impact of explicit government guarantees on the underlying collateral in securitizations issued by non-governmental entities. A case in point is the securitization of student loans issued by Sallie Mae – since the issuer is a private entity, banks must apply either the Gross-Up or SSFA method to determine applicable risk-weights, and neither method accounts for the fact that the underlying assets in the securitization are 97% guaranteed by the U.S. government, leaving the government in a 97% “first loss” position that is not reflected in the calculations. As a result, the risk-weights calculated under either method will grossly overstate the actual risk of loss in these tranches.

Overall, non-reliance on credit ratings caused by DFA Section 939A and now incorporated in the Standardized Approach NPR will have many adverse consequences for U.S. banks. It will force each U.S. banking organization to increase staffing or administrative cost to document the permissibility and risk weighting of each investment. This cost burden will likely be reflected in higher industry efficiency ratios and/or lower returns on investment securities as some banks opt out of investing in non-agency securities. We have provided herein a number of requests for clarification, forbearance, or change that we hope the Agencies will seriously consider to lessen the negative impact of the implementation of this Basel III requirement complicated by DFA Section 939A.

## 4. Capital Stress Testing

The application of stress testing to U.S. banks is not a specific Basel III requirement but rather derives from the Dodd-Frank Act Sections 165 and 166. The Basel III link arises from the inclusion in Basel III capital rules of section 10(d) that explicitly empowers supervisors to require higher capital ratios than would otherwise be required under Basel III “if the supervisor determines that the regulatory capital held by the banking organization is not commensurate with a banking organization’s credit, market, operational, or other risks.”<sup>15</sup> This uncertainty as to how stress-testing results could be used to require additional capital pursuant to section 10(d) should be clarified. Otherwise, bankers may rightly view the Basel III capital levels as floors with the Agencies free to impose additional requirements based on stress test results.

The importance of stress testing in any financially leveraged institution is axiomatic. That it be revisited and refined as a tool and control in banking regulation is logical, but this raises several important issues that should be addressed.

**First**, while the stated goal is to limit stress testing to U.S. banks above \$10 billion in assets, there is much history showing practices imposed on the larger banks eventually trickling down to much smaller banks. Despite the \$10 billion bright line, examiners of banks below this threshold will likely consider stress test loss ratios by category that are routinely established by the larger institutions as benchmarks for those below the asset threshold. In other words, while the smaller banks may not be required to conduct their own stress tests, the categorical loss ratios from the larger bank stress tests may inadvertently become standards for smaller banks.

Our clients have repeatedly indicated that such occurrences became a frequent frustration in the recent past. Regional and community bank portfolios have demonstrably different characteristics than large, national portfolios across many categories, which calls into question any sharp delineation by size, and more importantly demands a much higher level of training and vigilance for supervisory management to avoid such downstream migration.

Additionally, clearer stress assumption guidance and methodology is sorely needed for all banks, based on our discussions with many banks in recent months, including those above the \$10 billion asset threshold. We are finding that too many have no experience and little understanding of what the Agencies will require. The three conditions of baseline, adverse, and severely adverse are typically described with broad, macroeconomic assumptions. Such assumptions are theoretical in nature and, more importantly, extremely difficult to translate into likely future losses. This is particularly true for credit metrics, more so than discrete risks such as interest rate shocks.

**Second**, history has shown that predicted losses from prior stress tests have not proved to be accurate relative to actual losses. Stress modeling is unduly reliant on historical experience for data input, the integrity and sophistication of the model itself, and the ability to foresee the often un-foreseeable macroeconomic conditions across multiple sectors that can produce unusual stress and elevate systemic risk. Stress modeling spectacularly failed in bipolar fashion just over the last decade, by initial underestimation of intrinsic risk on a truly massive scale that led up to the last

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<sup>15</sup> Basel III NPR, 77 FR at 52801.

crisis, and then to arguably serious overestimation in the Supervisory Capital Assessment Program (“SCAP”) and Comprehensive Capital Assessment and Review (“CCAR”).

Financial institutions have incorporated internal stress testing for decades. Exhibit F below outlines results from some recent ones. Specific to the 2008 financial market crisis, with its residential mortgage market epicenter, the disturbing fact was not the lack of such stress testing but, rather, the failure to recognize the extraordinary degree of losses from a record housing price bubble that few foresaw. Through 2006 such stress tests typically assumed base case home price appreciation averaging 7% per annum, with an upside range well into double-digit growth, and a downside of flat to negative by only 3-5%. At the time these ranges were considered reasonable by regulators and the monetary authority. Of course the actual price collapse exceeded 35%.

Stress tests are only as good as their assumptions, and during this period such assumptions proved horribly off the mark on the low side. While it can be argued that the Agencies had less formal procedures for securing stress risks in credit during this period, it is highly doubtful that assumption guidelines for home pricing parameters would have considered anything remotely as dramatic as the 35%+ decline that subsequently took place on a national scale.

Significant overestimation by two separate Agencies is evident in the recently designed and led forward stress tests applied to our largest financial institutions. The first was substantially off the mark, and the second may have inadvertently double-counted embedded risk. The May 7, 2009 SCAP was self-described as an “unprecedented” and “stringent” exercise contemplating “a more severe recession than is anticipated.” The macroeconomic “more adverse” stress assumptions at the time included GDP, unemployment and home price projections for 2009 and 2010 that unfortunately were close to the actual economic performance of the U.S. economy.

The aggregate two-year cumulative loss ratio projected under this exercise was 9.6% of total loans, which matched that of the Great Depression. However, the actual losses in the banking system for those two years were barely half that amount! This suggests, despite best efforts and intentions, another widely off-the-mark error in the opposite direction, and the frustrating limitation of any model that attempts to quantitatively translate economic variables into credit impairment and embedded loss.

The subsequent March 13, 2012 CCAR has likewise produced exceptionally high ongoing losses, despite the Depression-level hurdles already absorbed by losses, reserves, and new capital to pass the SCAP.

The additional adverse-case loss hurdle was 8.1% of total loans over two years, despite a paucity of new lending since the previous stress test. This raises a second question: Were the original portfolio marks considered and counted, or have we inadvertently applied two consecutive Depressions in our stress assumptions? We also suspect that banks may not collect historical credit loss and reserving data against original principal in a fashion that is readily useful in showing previous risk absorption by loan category.

While the exercise of stress testing is certainly important, we are concerned that Basel III capital ratios become too vulnerable to stress extrapolations that can grossly underrate risk, as it did leading up to the 2008-2009 recession, as well as inadvertently overstate credit risk.

**Exhibit F**

Historical Stress Test Results

All FDIC-Insured Institutions	Historical	<i>SCAP</i>	Actual	<i>CCAR</i>
	5 yrs	<i>2-Yr</i>	2-Yr	<i>2-Yr</i>
	1990-95	<i>Mid-Point</i>	2009-10	<i>Adverse</i>
	Cumulative	<i>2009-10</i>	Cumulative	<i>4Q11-13</i>
		<i>Cumulative</i>		<i>Cumulative</i>
1-4 Family Residential	0.9%	<i>6.9%</i>	5.2%	<i>7.4%</i>
Non Residential (CRE)	5.1%	<i>8.0%</i>	2.1%	<i>5.2%</i>
Construction & Development	5.8%	<i>16.5%</i>	11.4%	
Home Equity	1.2%	<i>18.0%</i>	5.5%	<i>13.2%</i>
Multifamily	4.4%	<i>11.0%</i>	2.4%	
Real Estate - Other		<i>5.0%</i>		
Commercial & Industrial	5.3%	<i>6.5%</i>	4.2%	<i>8.2%</i>
Noncard to Individuals	4.0%	<i>10.0%</i>	5.0%	<i>5.9%</i>
Credit Cards	21.1%	<i>19.0%</i>	19.3%	<i>17.2%</i>
Other		<i>7.0%</i>	1.9%	<i>2.5%</i>
<b>Total Loans</b>	<b>4.5%</b>	<b><i>9.6%</i></b>	<b>5.1%</b>	<b><i>8.1%</i></b>

Source: FDIC, FactSet and Sandler O'Neill assumptions

*Third*, it is unclear how the ongoing annual and semi-annual stress testing for large institutions is expected to mesh with Basel III capital requirements. We are not suggesting supervisory stress testing be abandoned or diminished in any way. Instead we suggest that they be coordinated with the final Basel III rules rather than as additional requirements. We simply want to avoid the results of post-stress test capital ratios being used to require higher pre-stress test capital ratios than would otherwise be required under Basel III.

Under the proposed Prompt Corrective Action guidelines, insured depositories subject to stress testing are expected to be able to withstand worst-case stress testing and maintain a common equity capital ratio of at least 5%. This uncertainty as to how stress testing results could be used to require additional pre-stress capital ratios pursuant to section 10(d) should be clarified.

## 5. Corresponding Deductions from Capital

The proposed corresponding deduction approach governs the deduction from capital of certain investments in the capital instruments of other financial institutions.

These investments include non-significant capital investments and significant non-common stock capital investments in unconsolidated financial institutions, as well as reciprocal cross holdings by financial institutions of each other's capital instruments. Because ownership of more than 10% of the common stock of an unconsolidated financial institution is the threshold for "significant" investments, investments by U.S. banks would generally be "non-significant."<sup>16</sup>

To illustrate the corresponding deduction approach, the Agencies provide the helpful example of a banking organization owning a total of \$200 in non-significant investments in the capital of an unconsolidated financial institution, of which 50% consists of common stock, 30% consists of an additional tier 1 capital instrument (such as eligible preferred stock), and 20% consists of tier 2 capital subordinated debt. If \$100 of these investments exceeded an amount equal to 10% of the investing entity's common equity tier 1 capital elements, the investing entity would deduct \$50 from its own common equity elements, \$30 from its additional tier 1 capital elements, and \$20 from its tier 2 capital elements.

As a practical matter for U.S. banks, trust preferred securities are the capital instruments most likely to be subject to the corresponding deduction approach. In this regard, we believe it would be helpful for the Agencies to confirm that trust preferred securities should be deducted from the tier 2 capital elements of the investing entity, regardless of whether they are included in the tier 1 or tier 2 capital of the issuer or whether the investor itself has issued trust preferred securities.

Simplicity and certainty of application argue strongly for such clarification, both because trust preferred securities are tier 2 capital elements under the proposal and because it would be burdensome – even impracticable – for an investing entity to determine whether and to what extent trust preferred securities held are included in tier 1 versus tier 2 capital of the issuer. Any other similarly situated capital instruments should be treated in the same manner.

An additional point of clarification concerns the definition of the term *consolidation* for purposes of identifying investments in "unconsolidated" financial institutions. In the Basel III NPR the Agencies do not specify whether regulatory or financial consolidation is intended. The distinction could be important in certain situations, such as an entity deemed to be a bank holding company even though its investment in a bank fell short of the threshold for financial consolidation. Issues of the capital recognition of minority interests could also arise.

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<sup>16</sup> U.S. banking laws and regulations severely restrict the passive ownership by banks and their holding companies of the common stock of other financial institutions.

The Basel III Accord itself refers to investments “outside the scope of *regulatory* consolidation [emphasis added],” defined as “investments in entities that have not been consolidated at all or have not been consolidated in such a way as to result in their assets being included in the calculation of consolidated risk-weighted assets of the group.”<sup>17</sup> However, we believe the most natural reading of the NPR is to assume *financial* consolidation is intended, a reading reinforced by the Agencies’ reservation of authority to deem an entity to be consolidated for regulatory capital purposes even if it is not consolidated on the balance sheet of the investor.<sup>18</sup>

Regardless of whether we are correct, the Agencies could helpfully clarify the application of the consolidation threshold for purposes of the capital recognition of affected assets.

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<sup>17</sup> Basel III Accord (December 2010), p.25 & note 29.

<sup>18</sup> Basel III NPR, Section \_\_.1(d)(5) & (6) of proposed rule text.

## 6. Recognition of Minority Interests

Under the proposed Basel III capital rules, the calculation of the amount of minority interest that could count as common equity tier 1 capital, tier 1 leverage capital, or total capital has become unnecessarily complex and appears to have been designed to prevent potential abusive capital issuance rather than encourage third party investors to provide loss-absorbing capital. In contrast to the complexity of the proposed minority interest capital calculations, we suggest an alternative framework that similarly limits minority interests but in a manner closer to the simplicity of the current limitation.

**First**, for minority interests to count as common equity tier 1 capital, the issuer has to be a depository institution and the capital instrument has to meet all the criteria to qualify as common equity tier 1 capital. For minority interest capital to count as additional tier 1 or tier 2 capital, the issuer of the minority interest does not have to be a depository institution and the instrument must meet the criteria or either be considered additional tier 1 capital or tier 2 capital.

**Second**, under previous capital rules, the amount of minority interest that could count as additional tier 1 capital was based on core capital and calculated as 25% of pro forma tier 1 capital or 33% of existing core capital. This was a very straightforward formula that was easily calculated and monitored by banks of all sizes. In addition, it encouraged the investment of loss absorbing capital because the incremental investment by third party investors represented tier 1 capital dollar for dollar, subject to the 25% of pro forma tier 1 capital ceiling.

The proposed method for calculating the amount of bank level minority interest at the banking organization consists of eight variables and is overly complex:

- (a) Capital issued by subsidiary (\$)
- (b) Capital owned by third parties (%)
- (c) Amount of minority interest (\$) = (a) x (b)
- (d) Minimum capital requirement plus capital conservation buffer (%)
- (e) Minimum capital requirement plus capital conservation buffer (\$) (RWAs) x (d)
- (f) Surplus capital of subsidiary (\$) (a) - (e)
- (g) Surplus minority interest (\$) (f) \*(b)
- (h) Minority interest included at banking organization level (\$) (c) - (g)

Applying this methodology to calculate the permitted amount of tier 1 capital relative to current rules results in less tier 1 capital and also has the perverse result of reducing the amount of tier 1 qualifying capital as the percentage of third party investment increases. This would seem to be the opposite of what is intended where the surplus minority interest capital contributed to the subsidiary should increase rather than decrease Basel III capital and is certainly the opposite of current minority interest capital rules. But the Basel III rules clearly state that “the banking organization would not be able to include the portion of such surplus common equity tier 1 capital held by third party investors.”<sup>19</sup> The Agencies recognize the potential negative impact of these restrictions with their Question #26 on page 52817.

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<sup>19</sup> Basel III NPR, 77 FR at 52816.

We understand that the Basel III rules are designed to improve the quality of capital and that the amount of permitted additional tier 1 capital will be reduced from 25% to about 18% since common equity tier 1 must comprise at least 7% out of 8.5% of tier 1 capital. So third party surplus capital would be excluded. This seems to be at odds with supervisory intent to increase the amount of third party loss-absorbing capital.

**Third**, we recommend that the Agencies consider using the current minority interest framework and replace the 25% of core capital limitation with 18% of common equity tier 1 capital to be consistent with the Basel III requirements that common equity tier 1 capital comprise 82% (7%/8.5%) of tier 1 capital. Exhibit G demonstrates that if the minority interest capital rules were amended in this way, issuers could be assured that 100% of their net issuance amount up to the 18% threshold would count as tier 1 capital, with excess counting towards tier 2 capital. Any concerns that this simpler approach to minority interest capital calculation could be abused by sophisticated issuers using complex structures could be addressed by the requirement of agency approval of the capital treatment of instruments prior to issuance.

### Exhibit G

Comparison of Basel III Minority Interest Capital Rules to Current Rules and Potential Alternative (1)									
Total RWA	1000								
Beginning CET1	80								
Current Additional Tier 1 Limit	25.00%								
Potential Additional Tier 1 Limit	18.00%								
Comparison of Basel III Minority Interest Capital Rules to Current Rules and Potential Alternative (1)									
Additional Tier 1 Issuance Amount (\$)	Amount Included in Tier 1			Disallowed Amount			Disallowed %		
	BIII	Current (25%)	Potential (18%)	BIII	Current (25%)	Potential (18%)	BIII	Current (25%)	Potential (18%)
\$ 10.00	\$ 9.44	\$10.00	\$10.00	\$0.56	\$ -	\$ -	5.60%	0%	0%
\$ 15.00	\$ 13.42	\$15.00	\$15.00	\$1.58	\$ -	\$ -	10.53%	0%	0%
\$ 17.60	\$ 15.33	\$17.60	\$17.60 (2)	\$2.27	\$ -	\$ -	12.91%	0%	0%
\$ 20.00	\$ 17.00	\$20.00	\$17.76 (2)	\$3.00	\$ -	\$ 2.24	15.00%	0%	11%
\$ 25.00	\$ 20.24	\$25.00	\$17.76 (2)	\$4.76	\$ -	\$ 7.24	19.04%	0%	29%
\$ 30.00	\$ 23.18	\$26.64	\$17.76 (2)	\$6.82	\$3.36	\$12.24	22.73%	11%	41%
\$ 35.00	\$ 25.87	\$26.64	\$17.76 (2)	\$9.13	\$8.36	\$17.24	26.09%	24%	49%

(1) Current capital rules permit alternative tier 1 capital for up to 25% of core capital. The Basel III capital rules will limit alternative tier 1 capital to 18% of total tier 1 capital as common equity tier 1 must comprise as least 7% of the 8.5% of required tier 1 capital.

(2) This will be more efficient for banking organizations as they would have no restrictions on tier 1 capital qualifications for amounts issued less than 18% of pro forma tier 1 but would get no tier 1 credit for additional tier 1 capital issued in excess of 18% pro forma tier 1 capital.

## 7. REIT Preferred Consent Dividend

Since 1996, when REIT preferred was initially approved as a form of tier 1 capital, this instrument has been a popular form of additional tier 1 capital. One of the main reasons for the popularity of REIT preferred is the fact that the dividends are paid by the REIT from pre-tax earnings. With the phaseout of trust preferred securities as a form of tier 1 capital, REIT preferred becomes the only remaining form of tax-efficient tier 1 capital.

In order to qualify as tier 1 capital under current capital rules, REIT preferred securities are required to meet a number of specific criteria, including:

- Exchangeable automatically into noncumulative perpetual preferred stock of the banking organization if the banking organization becomes undercapitalized, is placed into receivership or conservatorship, or is expected to become undercapitalized in the near future
- Subordinated to depositors, general creditors, and subordinated debt holders of the banking organization in a receivership
- Not secured or guaranteed by the banking organization
- No maturity date and does not contain a rate step-up
- Callable only after 5 years following issuance unless upon a regulatory event
- Redemption or repurchase requires prior regulatory approval
- Dividends/capital distributions subject to cancellation at all times without restriction and without a credit-sensitive feature

The above criteria provide ample support for qualification of REIT preferred as alternative tier 1 capital and, to our knowledge, there has never been an explicit requirement for language permitting a REIT to declare a consent dividend such as the one proposed by the Agencies.<sup>20</sup> Additional support for our belief that such an express requirement is unnecessary for tier 1 capital inclusion is the fact that current IRC Section 565 (f)(1) allows a REIT to consent to nonpayment of a dividend due to financial circumstances and still maintain its REIT status.

Basel III now proposes to include an explicit consent dividend requirement for REIT preferred stock that, if not clarified or grandfathered, could be viewed as triggering a regulatory capital event call for existing REIT preferred stock issuances that lack explicit consent dividend language.

With the proposed Basel III phaseout of trust preferred securities, REIT preferred remains the only tax efficient form of additional tier 1 capital and is particularly attractive for smaller banks without efficient access to the capital markets. We recommend that the Agencies eliminate the proposed consent dividend requirement as unnecessary given the other requirements for tier 1 capital inclusion or, at the very least, grandfather existing issuances.

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<sup>20</sup> A consent dividend is a dividend that is not actually paid to the shareholders, but is kept as part of a company's retained earnings, yet the shareholders have consented to treat the dividend as if paid in cash and include it in gross income for tax purposes.

## 8. Trust Preferred Securities

Consistent with the Basel III Accord, the Agencies propose to phase out trust preferred securities from capital regardless of the asset size of the issuer. The only distinction between issuers with \$15 billion or more in assets and those with less than \$15 billion is a more aggressive phaseout for the former (ending in calendar year 2015) than for the latter (ending in calendar year 2021).

While the phaseout for larger issuers is consistent with section 171 of the Dodd-Frank Act, the phaseout for smaller issuers is much more aggressive. More specifically, whereas under Dodd-Frank and the current capital rules, a smaller issuer would enjoy full inclusion in consolidated tier 1 capital for the first 25 years of the 30-year term of a trust preferred security, under the Basel III NPR the security would be phased out over 10 years beginning in 2013.

To take the most punitive example using the last full year of grandfathered issuance under the Dodd-Frank Act, while a smaller issuer that had issued trust preferred securities in 2009 would enjoy full capital inclusion until 2034, such securities would be fully deducted from capital by the end of 2021 under the NPR's schedule.

We anticipate that some commenters will object that generally recognized principles of statutory and regulatory construction argue for resolving conflicts between the Dodd-Frank Act and Basel III in favor of Dodd-Frank. The basis of such an argument would be that because the provisions of Dodd-Frank are statutory expressions of congressional intent specific to banking organizations in the United States, they should trump conflicting Basel III provisions, and that the accelerated phaseout schedule for smaller issuers impermissibly contravenes section 171 of the Dodd-Frank Act. The counter-argument would be that Dodd-Frank does not limit the Federal Reserve Board's inherent authority to revise its capital rules consistent with safety and soundness.

Rather than join this legal debate, we urge the Agencies for numerous reasons to approach with extreme circumspection the accelerated deprivation for smaller issuers of capital recognition for trust preferred securities. Those reasons are as follows:

- Because Basel III is addressed to much larger banks than the smaller issuers of trust preferred securities, Dodd-Frank grandfathering of smaller issuers of trust preferred securities should have more weight with the Agencies.
- The capital levels of holding companies are less critical than those of their subsidiary depository institutions because bank deposits are federally insured and because banks generally are more important to the financial system than their parents.
- Because smaller issuers of trust preferred securities have less access to capital markets for purposes of refinancing trust preferred securities, their past reliance on the current capital regulations should weigh more heavily with the Agencies than the reliance of larger issuers.
- Many trust preferred securities are floating rate and thus represent an extremely cost-effective source of capital in the current historically low rate environment, and they could be refinanced only at significantly higher cost – if they could be refinanced at all.
- The protracted low rate environment is depressing asset yields and compressing net interest margins for all banks with no end in sight, increasing the importance of existing sources of low-cost capital for smaller banks without economies of scale.

- Smaller issuers of trust preferred securities that have also issued CPP or SBLF capital instruments will be challenged by the increased cost of capital on the latter instruments arising from their step-up coupons.

Dependence on trust preferred securities for consolidated tier 1 capital is heavily concentrated in issuers between \$500 million and \$10 billion, with a total of 485 such banks depending on trust preferred securities for 13.33% of tier 1 capital. Of these banks, 127 also have CPP or SBLF stock outstanding, and for the 190 total banks in this size cohort with CPP or SBLF outstanding, such stock accounts for 6.11% of tier 1 capital. In the aggregate, 576 banks have trust preferred securities outstanding, and 314 banks have CPP or SBLF stock outstanding.<sup>21</sup>

To conclude, there are more than sufficient reasons for the Agencies to lay a lighter hand on smaller issuers of trust preferred securities than they propose, and they should apply Dodd-Frank grandfathering to smaller issuers absent compelling safety and soundness considerations to the contrary that the Agencies have not advanced.

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<sup>21</sup> SNL Securities data as of 06/30/12.

## 9. M&A Growth Penalty

In connection with the accelerated phaseout of trust preferred securities for smaller issuers, the Agencies have also proposed what can best be described as an “M&A growth penalty” – trust preferred securities or other non-qualifying instruments issued by a smaller bank or thrift holding company that crosses the \$15 billion threshold through M&A activity (but not organic growth) would become subject to the more aggressive large-company phaseout.

We regard the distinction between organic and transactional growth for these purposes to be artificial. More importantly, we believe this M&A growth penalty would discourage the further consolidation of the banking industry, which is almost universally believed to be desirable, if not necessary. Particularly is this so among smaller banking companies because of the need to achieve a critical mass sufficient to shoulder growing compliance and other costs, which will be increased further by the Agencies’ proposed application of the Basel III capital rules to even the smallest depository institutions.<sup>22</sup>

We estimate there are 653 issuers of trust preferred securities smaller than \$15 billion in consolidated assets, whose aggregate outstanding trust preferred securities make up over 20% of their aggregate tier 1 capital compared to almost 20% for the median bank. Thus, the M&A growth penalty could pose a significant disincentive to consolidation involving smaller companies that materially rely on trust preferred securities for tier 1 capital.<sup>23</sup>

For these reasons, if the Agencies retain the accelerated phaseout of trust preferred securities for smaller issuers, we urge them to drop the proposed M&A growth penalty in favor of an approach that consistently applies the longer phaseout schedule to non-qualifying capital instruments based on their original eligibility regardless of whether the issuer subsequently crosses the \$15 billion threshold through acquisition, either as buyer or seller.<sup>24</sup>

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<sup>22</sup> Some 5,925 U.S. banks have less than \$500 million in assets, or 81% of all U.S. banks, per SNL Securities data as of 06/30/12.

<sup>23</sup> Our estimate is based upon a reconciliation of SNL Securities data for regulatory call reports and company financial statements as of 03/31/12. We excluded from the sample any companies for which SNL did not report tier 1 capital data.

<sup>24</sup> Such an approach appears consistent with section 171(b)(4)(C) of the Dodd-Frank Act, which grandfathers otherwise non-qualifying capital instruments based on their issuance before a date certain (05/19/10) by smaller issuers (<\$15 billion) as of another date certain (12/31/09). Because capital instruments rather than issuers are grandfathered, the subsequent growth or acquisition of issuers should not affect the status of grandfathered capital instruments.

## 10. Pension Assets & Liabilities

U.S. GAAP requires a banking organization that sponsors a single-employer defined benefit pension plan to recognize the overfunded or underfunded status of such a plan on its balance sheet as an asset or liability, with corresponding adjustments recognized in accumulated other comprehensive income ("AOCI"), a component of equity capital. The Agencies' current capital treatment derecognizes such tax-effected amounts, resulting in the exclusion from regulatory capital of any amounts recorded in AOCI resulting from the adoption and application of SFAS No. 158.<sup>25</sup>

Consistent with the Basel III Accord, the Agencies propose to recognize fully in common equity tier 1 capital defined benefit pension plan liabilities but to derecognize defined benefit pension plan assets except to the extent that a bank has "unrestricted and unfettered access" to such assets. The hallmark of such access is that the bank is "not required to request and receive specific approval from pension plan beneficiaries each time it would access excess funds in the plan." Absent this exception, the Basel III Accord would result in the punitive capital treatment of pension plan assets and liabilities, reducing capital by the amount of recognized assets as well as liabilities.

However, because the FDIC has unfettered access to the excess assets of an insured bank's pension plan in the event of receivership, the Agencies have determined that generally a bank would not be required to deduct any assets associated with a defined benefit pension plan from common equity tier 1 capital. Similarly, a holding company would not be required to deduct from capital any assets associated with a subsidiary bank's defined benefit pension plan.

We commend the Agencies for advancing the powers of the FDIC as receiver to secure for U.S. banks the even-handed, symmetrical capital treatment of defined benefit pension plan assets and liabilities. We note, however, that because whether a pension plan is overfunded or underfunded depends materially on the discount rate applied to very long-duration future cash flows, the assets and liabilities that the Agencies propose to recognize in regulatory capital arise in no small part from temporary economic and market fluctuations that can easily reverse and frequently do.

We therefore believe that the current exclusion from regulatory capital of such assets and liabilities is more consistent with safety and soundness than their proposed inclusion. Reinforcing our belief is the fact that in receivership the claims of the FDIC would be senior to those of the beneficiaries of underfunded defined benefit pension plans, who would have the status of unsecured general creditors of a bank sponsor.

In short, the inclusion in regulatory capital of pension assets and liabilities of U.S. banks recognized in AOCI would achieve nothing but the introduction of unnecessary and counterproductive capital volatility that would in no way further protect the insurance fund or taxpayers in the event of a receivership. For this reason, we urge the Agencies not to implement this provision of the Basel III Accord for U.S. banks.

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<sup>25</sup> Statement of Financial Accounting Standards No. 158, *Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans*, September 2006.

## 11. Small SLHC Capital Requirements

The proposed exemption of small bank holding companies – but not small savings and loan holding companies – from consolidated capital requirements reflects section 171 of the Dodd-Frank Act and the Federal Reserve Board's Small Bank Holding Company Policy Statement.<sup>26</sup> Specifically, the minimum capital requirements of section 171 do not apply to small BHCs that are subject to the Board's Small Bank Holding Company Policy Statement as in effect May 19, 2010. Because small SLHCs are not subject to that Policy Statement, the literal terms of section 171 do not exempt them from consolidated capital requirements.

In the absence of supervisory correction of what we believe was clearly legislative oversight, some 229 small SLHCs would have to convert their subsidiary depositories to bank charters to retain their exemption from consolidated minimum capital requirements.<sup>27</sup> We estimate the aggregate cost of such charter conversions to the capital accounts of the smallest thrifts to be over \$11 million, based on an expense of about \$50,000 per company in application and legal fees.

We note that the 111<sup>th</sup> Congress considered and rejected abolition of the Federal thrift charter in the course of the legislative process that culminated in the Dodd-Frank Act. We also note that the Board originally determined to exempt small BHCs from consolidated capital requirements to facilitate the transfer of ownership of small, private banks, which often requires the use of acquisition debt, and that this supervisory purpose applies no less to small thrifts than to small banks.

We therefore urge the Board to apply its Policy Statement to small SLHCs in order to give even-handed effect to that statement and to clear congressional intent to exempt small depository institution holding companies from consolidated capital requirements.

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<sup>26</sup> The Policy Statement is codified as Appendix C to Regulation Y, 12 CFR Part 225. Small BHCs are those with less than \$500 million in consolidated assets.

<sup>27</sup> Our quantification relies on our review of SNL data for thrifts filing Schedule HC of the TFR in 3Q2011.

## Conclusion

We appreciate the opportunity to provide these comments on behalf of Sandler O'Neill and be part of a constructive dialogue on the implementation of Basel III. We acknowledge the difficulty of conforming the Basel III rules developed among the G-20 countries to the U.S. banking market, where we have substantially more banking organizations with a wider range of business strategies and economic concerns. This difficulty is compounded by the need to conform the Basel III rules to the Dodd-Frank framework enacted by Congress. In this context, the "one size fits all" approach of Basel III needs to be honed and clarified to facilitate the practical implementation of Basel III for U.S. banking organizations in a way that enhances the quality and quantity of capital without unnecessary negative impacts on profitability and operating efficiency. We welcome the opportunity to discuss our comments or respond to any questions as the Agencies finalize the rules.

Sincerely,



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