October 22, 2012

VIA ELECTRONIC DELIVERY

Office of the Comptroller of the Currency
250 E Street SW
Mail Stop 2–3,
Washington, DC 20219

OCC, Docket ID OCC-2012-0008
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Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
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FDIC, RIN 3064-AD95
FDIC, RIN 3064-AD96


Ladies and Gentlemen:

The law firm of Covington & Burling LLP submits these comments, on behalf of a community bank client, in response to the proposed Numerator NPR and Standardized Approach NPR by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation (the “Agencies”).

The Basel III rules were designed to apply to large, internationally active banks. While many of the rules in the Numerator NPR and the Standardized Approach NPR reflect an important effort to conform U.S. capital rules to international standards, attempting to apply these rules to all banks within the United States, regardless of size and without significant modification, would substantially increase regulatory burden for smaller institutions, would not necessarily improve the correlation between capital and risk, and could very well cause significantly negative unintended consequences. We therefore request that institutions with under $15 billion in total consolidated assets be exempted from the Basel III regulations.

In addition, if smaller institutions are not exempted from the regulations, we, on behalf of our client, respectfully offer the following specific comments for consideration.

I. Basel III NPR

A. Removal of the Existing Filter for Accumulated Other Comprehensive Income

Current accounting standards require a financial institution to carry securities held in the available-for-sale account at fair value for financial accounting purposes. Changes in the fair value of such securities are not recorded on the financial institution's income statement as gains and losses, but instead are recorded as "accumulated other comprehensive income" ("AOCI") in shareholders' equity on the balance sheet. Under the Agencies' existing regulatory capital guidelines, adjustments to a financial institution's AOCI are reversed out of shareholders' equity in calculating regulatory capital.

The Numerator NPR proposes to remove the AOCI "filter" under current regulatory capital rules. Instead, financial institutions must include AOCI within Common Equity Tier 1 Capital ("CET1").\footnote{77 Fed. Reg. at 52,589, § 20(b)(3).} As a result, unrealized gains and losses accumulated from available for sale securities would impact regulatory capital measurements, resulting in unpredictable swings in regulatory capital due to interest rate fluctuations.

Although the proposed inclusion of AOCI in regulatory capital under the Numerator NPR reflects changes in the fair value of investments designated as available for sale ("AFS"), this rule does not provide for corresponding adjustments to regulatory capital for changes in the fair value of other assets and liabilities, even though fluctuating interest rates may have at least partially offsetting effects on the fair value of all of the bank's assets and liabilities.

Including AOCI within the regulatory capital calculation for CET1, apart from creating unpredictable swings in regulatory capital (some of which would inflate an institution's regulatory capital), would also have a number of other adverse consequences on banking institutions, including creating perverse investment incentives, raising mortgage lending rates, increasing interest rate risk, and decreasing liquidity. More specifically, it would motivate banks to do the following:
• **Reduce exposure to long-term investments like mortgage-backed securities.** Long-term investments experience greater shifts in fair value due to fluctuations in interest rates. Therefore, under the proposed Numerator NPR without the AOCI “filter,” banking organizations would have an incentive to avoid such investments, thereby increasing borrowing costs for long-term loans like mortgages.

• **Increase investment in short-term instruments.** The removal of the AOCI “filter” would cause financial institutions to invest a greater portion of their portfolios in short-term instruments whose fair market values are impacted less by interest rate fluctuations. Such governmental incentives to increase investments in short-term instruments would likely produce a sub-optimal rate of return on a bank’s portfolio of fixed income instruments.

• **Under-hedge interest rate risk exposure.** Banks often manage interest rate risk using cash flow hedges, such as interest rate swaps, to hedge floating-rate liabilities that are used to fund the banks’ AFS portfolios. These hedges increase the duration of the liabilities to match longer-duration AFS portfolio investments. The value of AFS investments and corresponding hedges vary inversely when interest rates fluctuate. As the Agencies recognized in the NPR, the proposed removal of the AOCI “filter” for AFS securities would force banks to recognize interest rate fluctuations in the value of AFS securities, but not in instruments that effectively hedge against this interest rate risk, thereby creating capital volatility. The asymmetric treatment of AFS securities and cash flow hedges would incentivize banks to avoid hedges that would actually reduce interest rate risk, and would further disincentivize investments in long-term AFS securities.

• **Increase designation of securities as held to maturity.** Because the proposed elimination of the AOCI “filter” would primarily impact AFS securities, financial institutions may also choose to designate more securities as held-to-maturity. While such designations would mitigate the significant fluctuations in a financial institution’s regulatory capital, this reallocation of securities would reduce the liquidity of the investment portfolio, limiting available liquidity during times of stress.

Although banking organizations may alter their investment and hedging activities to avoid mark-to-market impacts to regulatory capital levels, these actions would result in poorer

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' 77 Fed. Reg. at 52,819.'
investment choices and potentially increase interest-rate risk exposures. Therefore, we request that the Agencies retain the AOCI “filter” in its current form.

B. Capital Deduction for Holdings of TruPS Collateralized Debt Obligations (“TruPS CDOS”) in Excess of 10 Percent of CET1 Is Onerous and Unnecessary

Smaller banking organizations historically have had more difficulty than their larger counterparts in accessing the capital markets through the issuance of capital instruments. TruPS CDOs provided a means for smaller banking organizations, which may have been too small to access capital markets directly, to issue TruPS that were pooled into CDOs and sold into debt markets. To create a TruPS CDO, the TruPS underlying the CDO were pooled and tranching. Senior tranches in a TruPS CDO were insulated from losses by all of the subordinate tranches, reducing risk to the holders of the senior tranches. Investments by a banking organization in the senior tranches of a TruPS CDO are very different, and likely far less risky, than direct investments in capital instruments of other financial institutions, given their diversity and credit protection.

The Numerator NPR requires a banking organization holding a non-significant investment in the capital of an unconsolidated financial institution to calculate a Corresponding Deduction for amounts of the investments that exceed 10 percent of the banking organization’s CET1. We understand that the Agencies may intend to require banking organizations to calculate a Corresponding Deduction for investments in TruPS CDOs. For the reasons described below, we believe investments in TruPS CDOs should not be treated as investments in the capital of unconsolidated financial institutions, but rather should be treated strictly as “securitizations” and subject to risk-weighting consistent with the gross-up methodology currently in place or the SSFA introduced by the Standardized Approach NPR.

1. Benefits of the SSFA or Gross-Up Methodology

Both the SSFA described in the Standardized Approach NPR and the currently utilized gross-up methodology, which remains an option under the Standardized Approach NPR, use a risk-weighting methodology for TruPS CDOs that accounts for the tranching of securitizations in establishing a risk weight for such investments—tranching significantly impacts the risk of assets held by an institution—while the Corresponding Deduction ignores the tranching of TruPS CDOs and the risk mitigating features of such exposures, as discussed in

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6 In the event the Standardized Approach is not adopted, the current risk-based capital requirements would appropriately risk-weight TruPS CDOs.

7 Many TruPS CDOs have features providing a significant source of credit support, as discussed in greater detail below. For example, a TruPS CDO investment may have priority over other lower tranches in the CDO. Although the tranching of risk in a TruPS CDO would not be (continued...)
greater detail below.\footnote{8} The securitization rules under the Standardized Approach, in particular, factor in the presence or absence of subordinate tranches of securities in the securitization vehicle in determining the risk-weight to be assigned to the securities held by a banking organization.\footnote{9} Although we believe the SSFA should be modified to more accurately measure the true risk from such exposures, the methods for risk-weighting securitization exposures described in the Standardized Approach NPR are much more likely to provide for the accurate and appropriate capital treatment for TruPS CDO holdings than does the Corresponding Deduction.

In addition, it is important to note that the carrying value of TruPS CDOs at any given point reflects only the principal and interest that is expected to be recovered, in full, from holding these instruments. Projected losses to TruPS CDOs are considered losses via “other than temporary impairment” (“OTTI”), and are immediately written down through earnings. As a result of such write-downs, TruPS CDOs are appropriately valued on an institution’s balance sheet based on their underlying economics. The risk-weighting of TruPS CDO exposures that have already received a write down to purchase value further supports the view that treatment of TruPS CDOs as securitizations would provide sufficiently conservative treatment—even for lower tier tranches of the CDO. While lower tier tranches of a TruPS CDO may experience losses, the carrying value of the security already factors in any projected defaults, and the carrying value is also subject to super risk-weighting. Every tranche of a TruPS CDO held by a banking organization would be more accurately and appropriately risk-weighted as a securitization, rather than being subject to the Corresponding Deduction rules in the Numerator NPR.

The risk-weighting methods provided for in the Standardized Approach NPR, with minor modifications, would provide a better framework for taking such investments into account in the risk-based capital process than imposing a Corresponding Deduction. Therefore, we request that banking organizations holding TruPS CDOs be exempt from the Corresponding Deduction requirements of the Numerator NPR with respect to such investments. TruPS CDO exposures should be subject to risk weighting consistent with gross-up methodology or the SSFA under the Standardized Approach NPR, subject to our comments below. At a minimum, we request that the 10 percent CET1 limit be raised to 20 percent, allowing for additional holdings of TruPS CDOs to become subject to risk-weighting as securitizations rather than the capital deductions imposed under the Numerator NPR Corresponding Deduction rules.

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\footnote{8} Under the Standardized Approach NPR, TruPS CDO exposures would be super risk-weighted in accordance with the gross-up methodology or the SSFA.

\footnote{9} See 77 Fed. Reg. at 52,963–965.
2. Corresponding Deduction Issues

We believe the Corresponding Deduction fails to effectively address TruPS CDO investments held by a banking organization. The TruPS underlying a TruPS CDO may include over 30 separate issuers, potentially subject to different phase-out schedules. Provided a TruPS CDO investor could ascertain whether the underlying TruPS were capital instruments for the issuers, the Corresponding Deduction methodology still fails to appropriately take into account the tranche of TruPS CDO investments held by a banking organization. Different tranches of a TruPS CDO should not be viewed as owning a simple pro rata portion of the underlying TruPS; such a view fails to account for the senior or subordinate status of the TruPS CDO tranche. Under the rules for regulatory capital adjustments in the proposed Numerator NPR, a bank must take a Corresponding Deduction "from the component of capital for which the underlying instrument would qualify" if issued by the bank itself. The Corresponding Deduction is not administrable for TruPS CDO exposures; a banking organization could never issue only a particular tranche of a TruPS CDO.

We request that the Agencies amend the Numerator NPR and the Standardized Approach NPR to clarify that TruPS CDO exposures would only be subject to risk weighting consistent with the Standardized Approach NPR, and banking organizations would not be required to apply a Corresponding Deduction for TruPS CDO exposures. At a minimum, we request that the Agencies raise the 10 percent CET1 limit in the Corresponding Deduction Rules to 20 percent.

C. The Process of Deducting TruPS in Excess of 10 Percent of CET1 Using the Corresponding Deduction Approach Requires Clarification.

Under the Numerator NPR, a bank is required to deduct non-significant investments in the capital of unconsolidated financial institutions. In making this deduction, a bank is required to make such deductions "from the component of capital for which the underlying instrument would qualify if it were issued by the [BANK] itself." This requirement does not specify the timing for making this determination.

Should the Corresponding Deduction ultimately be applied to TruPS CDOs, we respectfully request that the Agencies clarify this ambiguity so as to avoid inconsistent approaches in calculating the Corresponding Deduction, particularly in light of the different rules phasing out TruPS from Tier 1 capital under the Basel III NPR. To calculate the Corresponding Deduction, a banking organization first needs to know whether the investment is an investment in a "capital instrument" of a financial institution. A bank would need to know the phase-out

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10 77 Fed. Reg. at 52,862, § __.22(c)(2).
11 See 77 Fed. Reg. at 52,862, § __.22(c)(4).
12 77 Fed. Reg. at 52,862, § __.22(c)(2).
schedule applicable to every TruPS issuer in every security owned and whether each TruPS issue (if subject to phase out) continues to qualify as a capital instrument. This would be extremely burdensome from a bookkeeping perspective given the potentially large number of issuers in each TruPS CDO deal.

We request that the Agencies clarify that a banking organization must take a Corresponding Deduction from the tier of capital for which the underlying instrument would qualify if the instrument were issued by the banking organization on the date of such calculation. Given that all TruPS would be considered Tier 2 capital if issued today, we therefore request that the Corresponding Deduction approach for TruPS (if ultimately required) be clarified to state that the deduction would be from Tier 2 capital in the first instance.

II. Standardized NPR

A. Maximum Risk Weights Should Be Capped at a Dollar-for-Dollar Capital Deduction.

The Standardized Approach NPR would impose a 1,250 percent risk-weight on certain exposures. The 1,250 percent maximum risk weight implies an 8 percent risk-based capital ratio requirement.\(^\text{14}\) Although it appears that the Agencies intended to impose a dollar-for-dollar capital charge for assets risk-weighted at 1,250 percent, the proposed rules would require all banking organizations to hold total capital of 10.5 percent (including the capital conservation buffer), and many institutions would likely maintain risk-based capital above even that level. This would imply a substantially lower risk-weighting to get to a dollar-for-dollar capital charge. As a result, under the Standardized Approach NPR, such banks would be required to hold more than a dollar-for-dollar amount of capital for assets risk-weighted at 1,250 percent. Such a result is punitive and makes no sense because it requires an institution to hold more capital against an asset than it could possibly lose on that asset.

Therefore, we request that the 1,250 percent maximum risk weight language be replaced with a requirement for a banking organization to impose a maximum risk-weight percentage that would result in a “dollar for dollar” capital charge based on the institution’s actual risk-based capital ratio.\(^\text{15}\)

\(^\text{14}\) As risk weights increase in the denominator, banking organizations must hold a greater amount of capital against the exposure. An institution subject to an 8 percent risk-based capital ratio requirement must hold capital in a dollar-for-dollar amount matched to 1,250 percent risk-weighted assets (i.e., 8 percent times 1,250 percent equals 100 percent).

\(^\text{15}\) The direct reduction methodology described in the current instructions to the call report should be retained to implement this proposed methodology. See FFIEC, Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041), at RC-R-25 (“when using the ‘direct reduction method,’ a bank includes an institution-specific amount in its risk-weighted assets for its ‘maximum contractual dollar amount of exposure’ that is calculated using (continued...)
B. Clarification of Risk-Weighting for TruPS CDOs

Based on the Standardized Approach NPR, it appears that an investment in a TruPS CDO would qualify as a "securitization" exposure. We request that the Agencies confirm that TruPS CDOs would be treated as securitizations under the Standardized Approach NPR.\(^{16}\)

Although we believe TruPS CDOs are most appropriately classified and risk-weighted as securitization exposures under the Standardized Approach NPR, we request that the Agencies amend and clarify the calculation of risk-weights for such assets under the SSFA. The rules for the risk-weighting of securitizations under the Standardized Approach ignore several unique features of TruPS CDOs that should be accounted for in the asset risk-weighting methodology, including the following: (1) contractual deferrals permitted under the terms of TruPS; (2) the presence of minor amounts of re-securitizations in many TruPS CDO issuances; and (3) certain credit support features of TruPS CDOs that provide additional protection against loss.

First, the risk-weighting rules under the SSFA appear to treat contractual deferrals of interest payments the same as defaults for the purpose of risk-weighting under Parameter W.\(^ {17}\) The market, including market participants, NRSROs, and examiners, have recognized that deferrals in TruPS are not necessarily indicative of pending defaults. Therefore, we request that the Agencies revise the SSFA methodology to make clear that TruPS that have contractual deferrals of interest payments would not be treated as being equivalent to defaulted exposures within the securitization pool if a bank has completed a credit analysis and concluded that the likelihood of default for such exposure is low.

Second, the SSFA requires significantly higher risk-weighting for securitizations in which even a small portion of the collateral constitutes a re-securitization.\(^ {18}\) Such an approach fails to recognize the relatively minor increased risk due to modest amounts of re-securitizations in the collateral underlying TruPS CDOs. As currently formulated under the Standardized Approach NPR, even a small amount of re-securitized collateral could taint the entire TruPS CDO. Therefore, we request that TruPS CDOs with less than 5 percent of re-securitized collateral be treated as securitizations (rather than re-securitizations) under the SSFA.

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the actual amount of the bank's total risk-based capital. This institution-specific calculation produces the effect of directly reducing Tier 1 and total risk-based capital by the "maximum contractual dollar amount of exposure\(^ 2\ldots\)".

\(^{16}\) See supra n. 6.

\(^{17}\) See 77 Fed. Reg. at 52,964, § .43(b)(2).

\(^{18}\) See 77 Fed. Reg. at 52,964, § .43(b)(5) (imposing a supervisory calibration parameter "p" of 0.5 for securitization exposures and of 1.5 for re-securitization exposures).
Finally, the SSFA fails to take into account certain credit support features commonly found in TruPS CDOs, and therefore imposes an inappropriately high risk weight for such exposures. For example, TruPS CDOs purchased at a discounted price, or which rely on excess spread within the deal, may experience significant protection against a loss relative to the investment that is not captured in the subordination-driven SSFA. Therefore, we request that such credit support elements as discounted purchase price and excess spread be considered as credit enhancement for purposes of the SSFA calculation.

III. The Proposed Numerator NPR and Standardized Approach NPR Will Significantly Harm Community Banks.

As described above, the proposed Basel III regulations would significantly harm community banks. The removal of the AOCI filter would cause our client to experience significant capital ratio volatility. Market fluctuations in interest rates will create significant swings in their regulatory capital levels – swings that are likely to misrepresent actual risk.

Should the changes requested herein not take effect with respect to TruPS CDOs, our client would experience significant declines in their capital ratios. Furthermore, liquidity in the TruPS CDO market is significantly limited at present, making the sale of such securities inconsistent with safe and sound banking practices, as the economic value of the securities would not be realized. The declines in capital ratios resulting from the treatment of TruPS CDOs would not reflect changes to the risk of the institution, and would ignore the conservative accounting and super risk weighting that are already in place for such investments.

IV. Conclusion

We appreciate your consideration of these important issues on our client’s behalf. For the reasons set forth earlier, the final rules implementing the Numerator NPR and the Standardized Approach NPR should exempt banks with less than $15 billion in total consolidated assets. At a minimum, the Agencies should amend the regulations as proposed above—retaining the AOCI filter, exempting TruPS CDOs from the regulatory capital deductions in the proposed Numerator NPR, treating all TruPS CDO exposures strictly as securitizations subject to risk weighting, and capping maximum risk weights at a dollar-for-dollar capital deduction consistent with an institution’s actual risk-based capital ratio—to ensure that these rules are reasonable, administrable, and fair.

Sincerely,

Keith A. Noreika