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August 11, 2014

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve
System
20th Street and Constitution Avenue, NW
Washington, DC 20551
regs.comments@federalreserve.gov
Docket No. R-1492
RIN 7100-AE 20

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
RIN 3064-AE18

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW
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Docket ID OCC-2014-0015
RIN 1557-AD85

**Re: Notice of Proposed Rulemaking Regarding Amendments to the Capital Plan
and Stress Test Rules**

Ladies and Gentlemen:

Capital One Financial Corporation (“Capital One”)¹ appreciates the opportunity to provide comments on the notice of proposed rulemaking (the “Federal Reserve Proposal”) issued by the Board of Governors of the Federal Reserve System (the “Federal Reserve”), the notice of proposed rulemaking (the “OCC Proposal”) issued by the Office of the Comptroller of the Currency (the “OCC”), and the notice of proposed rulemaking (the “FDIC Proposal”, and together with the Federal Reserve Proposal and the OCC Proposal, the “Proposals”) issued by the Federal Deposit Insurance Corporation (the “FDIC”, and together with the Federal Reserve

¹ Capital One Financial Corporation (www.capitalone.com) is a financial holding company whose subsidiaries, which include Capital One, N.A., and Capital One Bank (USA), N.A., had \$205.9 billion in deposits and \$298.3 billion in total assets as of June 30, 2014. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses, and commercial clients through a variety of channels. Capital One, N.A. has approximately 900 branch locations primarily in New York, New Jersey, Texas, Louisiana, Maryland, Virginia, and the District of Columbia. A Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol “COF” and is included in the S&P 100 index.

and the OCC, the “Agencies”).² Among other things, the Proposals would delay until 2016 the date by which a bank holding company or depository institution subject to the Basel III advanced approaches capital rules (“advanced approaches”) would be required to use the advanced approaches rules to estimate its regulatory capital in a given capital plan or stress test cycle.³ This comment letter supplements the comment letter that Capital One filed along with several other regional banks in response to the Proposals (the “Regional Bank Comment Letter”). We also participated in and support many of the positions expressed in the comment letters submitted by the Financial Services Roundtable and the American Bankers Association (“FSR/ABA Letter”) and The Clearing House Association L.L.C. (together with the FSR/ABA Letter, the “Trade Association Comment Letters”).

Capital planning and supervisory and company-run stress testing are among the most important innovations coming out of the recent financial crisis. These processes have strengthened balance sheets by increasing capital levels for banks and helped restore the public’s confidence in the U.S. financial system. Since the first Supervisory Capital Assessment Program, conducted jointly by the Agencies over an approximately two-month period in 2009, through the most recently completed 2014 stress testing and capital planning cycles, the Agencies have worked together with financial institutions to build out and improve these processes and the related supervisory framework. The Proposals include the latest examples of enhancements, including the shifting of the annual stress testing and capital planning cycles in response to industry feedback. We continue to believe that there are a number of opportunities for incremental improvements to enhance the effectiveness and credibility of these processes, some of which are addressed in the Regional Bank Comment Letter and the Trade Association Comment Letters, but the framework is a strong one and represents a marked improvement, both in utility and relevance, over the preexisting capital modeling regime.

Against this backdrop, and given the significance of this topic, we thought it important to submit this letter urging the Agencies to delay indefinitely any incorporation of the advanced approaches risk-based capital rules into the stress testing and capital planning processes. For the reasons set forth in this letter, we believe that incorporating advanced approaches into capital planning and stress testing will not enhance those processes, but rather compromise their integrity and effectiveness. Thus, we support the principle, set out in the Federal Reserve and OCC Proposals, of delaying the incorporation of advanced approaches into capital planning and stress testing. While we believe the proposal to make that delay effective until the 2016 capital planning and stress testing cycles is directionally correct, we urge the Agencies to make the delay indefinite. The capital planning and stress testing processes have benefited greatly from

² Federal Reserve, *Amendments to the Capital Plan and Stress Test Rules*, 79 Fed. Reg. 37420 (July 1, 2014); OCC, *Annual Stress Test—Schedule Shift and Adjustments to Regulatory Capital Projections*, 79 Fed. Reg. 37231 (July 1, 2014); FDIC, *Annual Stress Test*, 79 FR 37235 (July 1, 2014).

³ We note that the FDIC Proposal does not directly amend the date by which an FDIC-supervised depository institution subject to advanced approaches would be required to use the advanced approaches rules to estimate its regulatory capital in a given stress test cycle. We understand that, to date, no FDIC-supervised depository institution has been approved to exit parallel run, which is a prerequisite to using advanced approaches.

being straight-forward, credible, and transparent. Conversely, we do not believe these processes will benefit from the more complex and opaque nature of advanced approaches.

We believe that incorporating advanced approaches into the capital planning and stress testing processes would cause them to take on the inherent weaknesses of advanced approaches, which are widely known among key policymakers, in the United States and abroad. A summary of recent statements by key policymakers in this regard is included in Appendix A to this letter.⁴ Allowing those weaknesses to become embedded in the capital planning and stress testing processes could lead to significant damage to the integrity and utility of those processes, and thus threaten the credibility they have earned with the public, the markets, and the financial services industry. Moreover, incorporating advanced approaches into the capital planning and stress testing processes would be premature in light of increasing statements by key policymakers that advanced approaches should be eliminated from the U.S. risk-weighted capital framework.⁵

The advanced approaches framework suffers from numerous weaknesses, which stand in sharp contrast to the strengths of the capital planning and stress testing processes. We have attached as Appendix B to this letter a matrix, which is not intended to be exhaustive, that compares the strengths of the capital planning framework to the weaknesses of the advanced approaches risk-based capital rules, and also sets forth the negative implications of incorporating advanced approaches into capital planning.

On a more practical note, advanced approaches, and incorporation of advanced approaches into capital planning and stress testing, both at banks and at the Agencies, represents a poor return on a considerable investment. The costs to institutions of using advanced approaches to calculate risk-weighted assets are extraordinarily high, and the benefits difficult to identify or quantify. As Andrew Haldane, the Executive Director of the Bank of England, stated in 2011, speaking of the extraordinary complexity of advanced approaches:

[C]onsider the position of a large, representative bank using an advanced internal set of models to calibrate capital. Its number of risk buckets has increased from around seven under Basel I to, on a conservative estimate, over 200,000 under

⁴ We note that the FDIC issued a notice of proposed rulemaking that would eliminate banks' ability to use advanced approaches internal models in measuring counterparty exposure, which is a factor used by the largest, most complex banks to determine their FDIC deposit assessments. In so doing, the FDIC cited some of the same weaknesses previously identified with respect to measuring risk using internal models under advanced approaches. FDIC, *Assessments*, 79 FR 42698 (July 23, 2014) ("Based on preliminary assessments data, the adoption of the IMM by itself will cause a significant reduction in counterparty exposure amounts and change the scorecard results in a way that significantly reduces deposit insurance assessments for the banks using the IMM. This significant reduction in assessments does not appear to be driven primarily by a change in risk exposure, but rather by a change in measurement methodology.").

⁵ For example, in May this year, Governor Tarullo urged consideration of "discarding the IRB approach to risk-weighted capital requirements," Governor Daniel K. Tarullo, *Rethinking the Aims of Prudential Regulation*, May 8, 2014, at 15; and in July, Vice Chairman Hoenig stated that U.S. regulators "should turn very carefully away from the internal models", Vice Chairman Thomas M. Hoenig, *Remarks at FDIC Open Meeting*, July 16, 2014. We support calls by policymakers to eliminate advanced approaches from risk-based capital requirements due to its inherent weaknesses.

Basel II. To determine the regulatory capital ratio of this bank, the number of calculations has risen from single figures to over 200 million. The quant and the computer have displaced the clerk and the envelope.

At one level, this is technical progress; it is the appliance of science to risk management. But there are costs. Given such complexity, it has become increasingly difficult for regulators and market participants to vouch for the accuracy of reported capital ratios. They are no longer easily verifiable or transparent. They are as much an article of faith as fact, as much art as science. This weakens both Pillars II and III. For what the market cannot observe, it is unlikely to be able to exercise discipline over. And what the regulator cannot verify, it is unlikely to be able to exercise supervision over. Banks themselves have recently begun to voice just such concerns.⁶

Mr. Haldane's estimates of the complexity of advanced approaches will be multiplied by many factors when one accounts for the fact that his estimates only relate to a point in time calculation (i.e., risk-weighted capital ratio at a quarter-end or year-end date). The incorporation of advanced approaches into capital planning and stress testing would increase massively the number of required calculations by each scenario that a financial institution runs (both supervisory scenarios and institution-developed scenarios) and by the number of points in time that the calculations are to be run (currently nine quarters).⁷

We would expect that the cost to the Agencies to incorporate advanced approaches into capital planning and stress testing would be prohibitively expensive due to the same complexity. We believe that the adoption of advanced approaches in capital planning and stress testing would in fact be value-reducing, as it would divert financial and technical resources from capital planning and stress testing at banks, including critical time of the boards of directors and management, and at the Agencies, at both the staff and principal levels.

With the increasing tide against advanced approaches in the risk-weighted capital framework, it would seem incongruous to introduce the concept into capital planning and stress testing. Delaying indefinitely any incorporation of advanced approaches into these processes would help preserve their integrity, while allowing the broader process of evaluating the future wind down of advanced approaches, either at all U.S. banks or at least to those that are not globally systemically important, to proceed to its inevitable conclusion.

⁶ Andrew G. Haldane, *Capital Discipline*, January 9, 2011, at 2-3, available at <http://www.bis.org/review/r110325a.pdf>.

⁷ For example, if it is assumed that an institution is subject to three supervisory scenarios (baseline, adverse, and severely adverse) and two institution-developed scenarios, the number of calculations that would be required using Mr. Haldane's estimates balloons from approximately 200 million to approximately *9 billion*.

* * *

We appreciate the opportunity to comment on the Proposals and would be happy to discuss any questions regarding the content of this letter.

Sincerely,

/s/

Robert Zizka
Executive Vice President –
Balance Sheet Management

Recent Policymaker Statements on Advanced Approaches

Governor Daniel K. Tarullo, *Rethinking the Aims of Prudential Regulation*, May 8, 2014

The combined complexity and opacity of risk weights generated by each banking organization for purposes of its regulatory capital requirement create manifold risks of gaming, mistake, and monitoring difficulty. The IRB approach contributes little to market understanding of large banks' balance sheets, and thus fails to strengthen market discipline. And the relatively short, backward-looking basis for generating risk weights makes the resulting capital standards likely to be excessively pro-cyclical and insufficiently sensitive to tail risk. That is, the IRB approach—for all its complexity and expense—does not do a very good job of advancing the financial stability and macroprudential aims of prudential regulation.

Vice Chairman Stanley Fischer, *Financial Sector Reform: How Far Are We?*, July 10, 2014

Following the global crisis, the BCBS moved to the Basel III agreement, which strengthens capital requirements, as opposed to Basel II, which tried to build primarily on measures of risk capital set by internal models developed by each individual bank. This approach did not work, partly because the agreed regulatory minimum capital ratios were too low, but also because any set of risk weights involves judgments, and human nature would rarely result in choices that made for higher risk weights.

Vice Chairman Thomas M. Hoenig, *Remarks at FDIC Open Meeting*, July 16, 2014

I particularly think that we should turn very carefully away from the internal models since they are being shown on a global basis to vary dramatically among institutions, not based on the assets held but on the weightings sometimes assigned.

Director Jeremiah O. Norton, *A More Prominent Role for the Leverage Ratio in the Capital Framework*, February 6, 2013

Despite their sophistication, the models used to measure RWAs may not produce sufficiently accurate measures of capital adequacy. . . . The notion that investors do not understand risk weightings is supported by market research. A recent survey of 130 bank investors at more than 100 institutions suggested that they do not trust RWAs and the Internal Ratings Based model adopted as part of the Basel agreement for the largest banks to do their own modeling of RWAs. Research also indicates that it is more difficult for investors to make comparisons of the riskiness of a bank's assets, even within specific asset classes. This lack of transparency could reduce the efficiency of banking markets and lead investors to become overly reliant on regulatory exercises and judgment. . . . Further, there is the persistent danger that the complexity of Basel capital models will prevent regulatory authorities, who have an even a greater level of access to company information, from using Basel capital measurements to arrive at an accurate assessment of a bank's capital adequacy.

Andrew Bailey, Bank of England 2012 Financial Stability Report, Testimony before the Treasury Select Committee – U.K. House of Commons, January 15, 2013

Investors “do not understand” risk-weighted assets and “have lost confidence in it.”

Comparison of Regulatory Capital Regimes

Category	Stress Tests (CCAR, DFAST)	Advanced Approaches (AA)	Stress Tests Using AA
<i>Complexity</i>	<ul style="list-style-type: none"> • Highly complex, but reflects real world dynamics and ways business is run and modeled • Built around pre-existing forecasting processes • Large number of models reviewed by banks' model governance processes • Complexity is warranted given its objective and is worthwhile since it's actionable 	<ul style="list-style-type: none"> • Uses over 200,000 risk buckets and hundreds of millions of calculations (<i>A. Haldane Comments</i>) • Takes a large amount of computing time to create risk weights for a single point in time 	<ul style="list-style-type: none"> • Would add to complexity in a multiplicative fashion • Would add massive burden/risk to both banks' and the Fed's existing quantitative and qualitative challenges • Unclear how Fed models could remain independent yet comparable across banks while tying to initial AA capital levels (given individual banks' unique models) • Projecting risk weights for 9 quarters across both supervisory and bank-developed scenarios in tight time frames would require approximations and estimates of AA, at which point any "advantage" over Standardized of greater risk sensitivity may be lost
<i>Transparency / Opacity</i>	<ul style="list-style-type: none"> • Final output format is comparable to internal management reporting and industry analyst reports (i.e., it looks like how the world views performance) • Well understood by debt and equity investors • Provides a simultaneous view of each firm's capital position under stress 	<ul style="list-style-type: none"> • Not well understood by debt and equity investors • Viewed with significant market skepticism • Capital ratios are anything but transparent (analysts for example are unable to recreate results) 	<ul style="list-style-type: none"> • Inherent opacity of AA could reduce credibility of CCAR

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 Appendix B – Comparison of Regulatory Capital Regimes

Category	Stress Tests (CCAR, DFAST)	Advanced Approaches (AA)	Stress Tests Using AA
<i>Comparability</i>	<ul style="list-style-type: none"> • Readily comparable across banks of different size and complexity because scenarios and assumptions are known and the Fed conducts the stress testing 	<ul style="list-style-type: none"> • Inherent complexity and sensitivity to key inputs and assumptions undermines comparability • European experience demonstrates lack of consistency across different banks 	<ul style="list-style-type: none"> • Customized nature of AA would require significant simplification of each bank’s estimates for comparability
<i>Generation of risk insights</i>	<ul style="list-style-type: none"> • Helps Management and Boards identify, manage, and govern risks • Promotes tangible and actionable discussion about the most critical risks 	<ul style="list-style-type: none"> • Limited utility to Management and Boards • More of a math exercise • Focused on known risks where losses have historically been observed 	<ul style="list-style-type: none"> • AA complexity corrupts the clarity of stress testing
<i>Ability to manage and supervise (Management, Board, Regulators)</i>	<ul style="list-style-type: none"> • Management and Boards highly engaged in effective challenge • Designed so as not to be “gamed” 	<ul style="list-style-type: none"> • A “black- box” • Difficult for executives to draw out the “so whats” • Difficult to compare across asset classes let alone across institutions 	<ul style="list-style-type: none"> • Difficult for Management and Boards to provide effective challenge to AA ratios under stress modeling • Risk that complexity obfuscates supervisory insights
<i>Sensibility</i>	<ul style="list-style-type: none"> • Incorporates both losses and revenues under stressed conditions • Blends model-driven insights with management judgment and conservative overlays 	<ul style="list-style-type: none"> • Only addresses stressed losses – assumes no revenue under stress • Uses arcane formulaic extrapolations 	<ul style="list-style-type: none"> • Double counts credit and operational loss impacts as they are in both the numerator (higher losses, lower earnings) and denominator (higher risk weights)

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<i>Forward- vs. backward-looking</i>	<ul style="list-style-type: none"> • By design, forward looking • Informed by historical observation, key learnings, and emerging risks • Results less dependent on “point in the cycle” 	<ul style="list-style-type: none"> • Formulaically backward looking • Formulaically pro-cyclical (and highly dependent on point in the cycle) 	<ul style="list-style-type: none"> • Could obscure the forward-looking clarity of CCAR
<i>Credibility</i>	<ul style="list-style-type: none"> • Helped restore public confidence in the U.S. financial system – massive credibility built • Straightforward framework with good “bone structure” 	<ul style="list-style-type: none"> • Very low 	<ul style="list-style-type: none"> • Risk to credibility of stress testing given opacity of models and inability to easily make comparisons across firms
<i>Time and resource investment</i>	<ul style="list-style-type: none"> • The Fed was able to conduct SCAP in about two months during a recession by leveraging existing Basel I framework approach and forecasting processes 	<ul style="list-style-type: none"> • Over six years have passed between the final AA capital rule and the first exits from parallel run due to the effort required to build, review, and validate the new models and implement the regulatory framework • Large resource effort for banks to produce “moment in time” measures 	<ul style="list-style-type: none"> • Incorporation of AA into CCAR has been delayed, and it’s unclear how many hours of regulatory staff resources will be required to complete the process • Would crowd out ability to continue to invest in meaningful improvements in other CCAR areas • Would require significant investment in regulatory modeling frameworks to build forward looking AA measures with de-minimus benefit