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September 22, 2014

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
50 17th Street, N.W.
Washington, D.C. 20429

Re: Notice of Proposed Rulemaking and Request for Comments – Assessments; RIN 3064 AE16

Mr. Feldman:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Notice of Proposed Rulemaking[2] from the Federal Deposit Insurance Corporation (FDIC) to incorporate aspects of the U.S. Basel III capital rules (Basel III)[3] into its assessments system. This letter addresses the parts of the proposal dealing with calculation of counterparty exposures in the Highly Complex Institution (HCI) scorecard and the assessment base calculation for custodial banks.

With respect to the proposed calculation of counterparty exposures in the HCI scorecard, the FDIC is required in statute to assess premiums based on three factors: (1) the probability that a bank will fail and cause a loss for its insurance fund, (2) the likely amount of such loss, and (3) revenue needs of the fund.[4] Basing assessments on the risk exposure to individual banks, as per the first two factors, should lead to premiums that reward banks for holding lower-risk portfolios and for having strong risk management. Accordingly, it should lead to premiums being assessed equitably across banks.

The proposed measurement change has not been demonstrated to be consistent with this statutory mandate. It would eliminate use of the Internal Models Method (IMM), a risk measurement system, which a bank cannot use without certification by its primary supervisor. Instead, HCIs would be required to use a measurement with demonstrable weaknesses.

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[1] The American Bankers Association is the voice of the nation's $15 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $11½ trillion in deposits and extend $8 trillion in loans.
[2] 79 Federal Register 42698, July 23, 2014, *www.gpo.gov/fdsys/pkg/FR-2014-07-23/pdf/2014-16963.pdf*.
[3] 78 Federal Register 55340, September 10, 2013; 78 Federal Register 62018, October 11, 2013; and 79 Federal Register 20754, April 14, 2014.
[4] Federal Deposit Insurance Act §7(b)(1) (12 USC 1817(b)(1)).

In brief with respect to this proposed change, ABA recommends that:

- The measurement of counterparty exposure for derivatives should recognize the risk-mitigating effects of financial collateral.

- Certain types of exposure should be excluded from the counterparty exposure measures:
  - Qualifying Central Counterparties (QCCPs)[5] (whose use is designed to reduce risk to banks and the financial system);
  - affiliates (considering the heightened, risk-reducing prudential requirements for transactions between banks and their affiliates); and
  - non-U.S. sovereigns that meet the standards for Level 1 high quality liquid assets (HQLA) under the Liquidity Coverage Ratio rule.

- Use of IMM to measure counterparty exposure should continue to be permitted.

- Any recalibration of the HCI scorecard to account for a change in the counterparty exposure measure should first be proposed for public comment.

With respect to the proposed lowering of deductions from a custodial bank's assessment base, ABA supports modification in light of the new Basel III rules. However, we suggest that the proposal has gone too far in cutting out of the deduction some low-risk, liquid assets that are integral elements of a custodial bank's portfolio.

In brief with respect to this proposed change, ABA recommends that:

- Low-risk securitization exposures should continue to qualify for the custodial bank deduction due to their strong credit and liquidity profiles.

- The custodial bank deduction should leverage the increased granularity in risk measurement introduced by Basel III.

These points are considered in detail below.

[5] A QCCP is a central counterparty that meets standards established by the Committee on Payment and Settlement Systems (CPSS) and the International Organization of Securities Commissions (IOSCO). (78 Federal Register 62018, October 11, 2013, at 62097; 78 Federal Register 55340, September 10, 2013, at 55414)

Calculation of Counterparty Exposures in the Highly Complex Institution Scorecard

The balance of the largest and the twenty-largest exposures to counterparties are both factors in the scorecard that determines the assessment rate for Highly Complex Institutions[6] – in fact, the determining factor for some. As proposed, HCIs would report counterparty exposures for calculation of assessments based on the Basel III Standardized Approach starting in first quarter 2015; they would no longer be permitted to qualify to use the IMM.

The proposed approach does not achieve the statutory mandate of assessments based on risk; to do so it would have to recognize the risk mitigating benefits of collateral and the minimal risk of central counterparties (CCPs). As discussed below, ABA recommends that these deficiencies be corrected in the final rule, and that banks should be permitted to qualify to measure counterparty exposures using IMM unless and until there is documented inadequacy of this approach, or superiority of an alternative approach, to gauge counterparty exposures.

<u>Recognition of Collateral</u>

The proposed measure of exposure for derivatives would be the "credit equivalent amount under the Standardized Approach [which] is the sum of current credit exposure and potential future exposure without reduction for collateral."[7] **ABA recommends that the measure of counterparty exposure for the HCI scorecard should fully recognize the credit risk mitigation benefits of financial collateral, as permitted under the Standardized Approach.**[8] Collateral reduces the risk relating to future exposure a bank may have to a counterparty through the duration of a derivative transaction. This protection has been officially recognized by Congress in enacting the Dodd-Frank Act[9] and in the margin requirements instituted by individual clearing houses.[10] The HCI scorecard should similarly take account of the risk mitigating effects on derivative exposures from financial collateral.

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[6] A bank qualifies as a HCI if it has $50 billion or more of assets (excluding credit card banks) and is controlled by a holding company with $500 billion or more of assets, or is a processing or bank or trust. (12 CFR. 327.8(g))

One element of the HCI scorecard is a "Concentration Measure" that equals the greater of (i) largest counterparty exposure/tier 1 capital and reserves; (ii) top 20 counterparty exposures/tier 1 capital and reserves; and (iii) the higher-risk assets/tier 1 capital and reserves.

[7] Proposal, page 42704.

[8] 12 CFR §3.34(b), §217.34(b), and §324.34(b) provide that a bank may use the (i) simple approach or (ii) collateral haircut approach for eligible margin loans "to recognize the risk-mitigating effects of financial collateral".

[9] The Dodd–Frank Wall Street Reform and Consumer Protection Act (PL 111–203) §731 requires a swap dealer or major swap participants to meet margin requirements on uncleared swaps that are established by its prudential regulator, and if there is no regulator then it must comply with Commodity Futures Trading Commission ("CFTC") regulations governing margins.

[10] Central counterparties require their counterparties to post specific initial margins and variation margins on trades. Clearing members are required to post high-quality, liquid collateral for the initial margin. The variation margin is typically settled in cash in the relevant currency. The central counterparty does

Exclusion of Types of Counterparty Exposure

Qualifying Central Counterparties

ABA recommends that exposures to QCCPs should be excluded from the counterparty exposure measures in light of the capital and other prudential requirements to which they are subject. The rigorous requirements that apply to QCCPs ensure that exposures to these entities should not be expected to expose the bank, and, by extension, the FDIC's insurance fund, to meaningful risk.[11]

Mandatory clearing and lower capital requirements for certain cleared transactions is intended to drive a significant amount of derivatives activity to CCPs, away from bilateral OTC transactions.[12] As a result, CCPs are already among the largest counterparties for several HCIs, and will likely come to dominate the top 20 counterparty measure for those banks as more trades become subject to mandatory clearing.

Centralized clearing has been recognized, including by the FDIC, as a key element of financial reform in order to reduce risk exposure for individual banks and the financial system overall.[13]

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not post initial margin to its clearing members; should a clearing member default, the central counterparty will use the initial margin of the defaulter to satisfy amounts owed to other clearing members.

[11] A QCCPs is subject to stringent standards, including a requirement that it "is based and prudentially supervised in a jurisdiction where the relevant regulator/overseer has established, and publicly indicated that it applies to the QCCP on an ongoing basis, domestic rules and regulations that are consistent with the [Committee on Payment and Settlement Systems – International Organization of Securities Commissions] Principles for Financial Market Infrastructures." (Basel Committee on Banking Supervision, *Capital Requirements for Bank Exposures to Central Counterparties*, July 2012, page 1, www.bis.org/publ/bcbs227.pdf)

[12] Under Basel III, a two percent risk weight is assigned to exposures related to transactions cleared with a QCCP; higher risk weights apply for exposures to non-CCP counterparties. Therefore, it is more expensive for a bank to enter into bilateral OTC derivatives transactions. (78 Federal Register 55340, September 10, 2013, at 55418; 78 Federal Register 62018, October 11, 2013 at 62100)

[13] "Central clearing, margin, and capital requirements as a systemic risk management tool: … With appropriate collateral and margin requirements, a central clearing organization can substantially reduce counterparty risk and provide an organized mechanism for clearing transactions… While large losses are to be expected in derivatives trading, if those positions are fully margined there will be no loss to counterparties and the overall financial system and none of the uncertainty about potential exposures that contributed to the panic in 2008." (S. Rep. 11-176, April 30, 2010, page 33, www.banking.senate.gov/public/_files/Comittee_Report_S_Rept_111_176.pdf.)

"The [Basel Committee] and the [Federal banking] agencies support incentives designed to encourage clearing of derivatives and repo-style transactions through a CCP wherever possible in order to promote transparency, multilateral netting, and robust risk-management practices … Although there are some risks associated with CCPs, … the FDIC believes that CCPs generally help improve the safety and soundness of the derivatives and repo-style transactions markets through the multilateral netting of exposures, establishment and enforcement of collateral requirements, and the promotion of market transparency." (78 Federal Register 55340, September 10, 2013, at 55414).

For this reason, Congress encouraged use of QCCPs through enactment of the Dodd-Frank Act.[14] HCIs should not be penalized with higher FDIC assessments for use of risk-reducing CCPs.

Affiliated Entities

In light of the comprehensive safeguards for transactions between a bank and its affiliates, ABA recommends that these exposures not count as counterparty exposures in the HCI scorecard. A bank's affiliate transactions are limited to ten percent of capital stock plus surplus for any single affiliate and twenty percent for all affiliates combined, where the restricted transactions include asset purchases and credit extensions.[15] The Dodd-Frank Act expanded the list of restricted transactions to include derivative transactions, securities repurchase transactions, and securities borrowing and lending.[16] There are also collateral requirements on the credit exposure from derivative transactions with affiliates.[17]

This issue is of some importance to HCIs because, as concentration in CCP exposures grows (as above), transactions with affiliates are likely to be among the top 20 exposures. Thus, even if a bank has not increased affiliate transactions, so there is no increase in risk exposure to itself of the FDIC insurance fund, its top-20 counterparty measure and FDIC assessments may rise.

Non-U.S. Sovereigns

Exposures to the U.S. Government and its departments and agencies that are unconditionally guaranteed by the full faith and credit of the United States are explicitly excluded from the HCI scorecard counterparty exposures measures.[18] Exposures to non-U.S. sovereigns of comparable credit quality and are highly liquid warrant similar treatment.

The U.S. regulatory agencies, including the FDIC, have developed criteria in other regulatory contexts for certain exposures to non-U.S. sovereigns to be treated as equivalent to exposures to

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[14] Title VII of the Dodd–Frank Wall Street Reform and Consumer Protection Act (PL 111–203) requires that a swap is to be cleared through a "central clearing party" (CCP) if the U.S. Commodity Futures Trading Commission (CFTC) determines that the swap, or group, category, type, or class of swap, is required to be cleared (unless an exception applies). The CFTC has determined that certain credit default swaps and interest rate swaps must be cleared.
[15] Federal Reserve Act §23A(a)(1) (12 USC §371c(a)(1)), codified in Federal Reserve Regulation W (12 CFR §223.11 and §223.12), limits the amount of a bank's asset purchases from, plus loans to, plus derivative and securities transactions with, plus securities borrowing and lending to, any single affiliate to ten percent of the bank's capital stock and surplus, and to twenty percent for all affiliates combined.
[16] Federal Reserve Act, Section 23A(b)(7) (12 USC §371c(b)(7)).
[17] Federal Reserve Act §23A(c)(1) (12 USC §371c(c)(1)) and Regulation W (12 CFR §223.14) require collateralization for transactions with affiliates ranging from 100 percent (for obligations of and guaranteed by the United States and its agencies) to 130 percent (for stock, lease, or other real person property as collateral). Derivative transactions with affiliates are subject to Federal Reserve Act §23B.
[18] Proposal, pages 42703, 42704 and 42707.

the United States. The Basel III Standardized Approach could serve in the present context. The Standardized Approach assigns a zero percent risk weight to foreign sovereign exposures based on either the Organization for Economic Cooperation and Development's (OECD) Country Risk Classification (CRC) or the sovereign's OECD membership status if no CRC exists.[19] Since exposures to non-U.S. sovereigns that are full OECD members and carry zero capital risk weights are seen as riskless to the bank under Basel III, these exposures similarly involve no risk to the FDIC insurance fund and should be excluded from the HCI scorecard counterparty exposures measures.

The Standardized Approach focuses on the credit risk of sovereign exposures. To address concerns for liquidity, we suggest exclusion for non-U.S. sovereigns that meet the criteria for obligations that qualify as Level 1 high quality liquid assets (HQLA) under the Liquidity Coverage Ratio rule.[20] To qualify as a Level 1 HQLA, an asset much have a proven record as a reliable sources of liquidity during stressed market conditions. As noted in the rule, "The [Federal banking] agencies believe that sovereign obligations that continue to qualify for a zero percent risk weight have shown resilient liquidity characteristics.[21]

Internal Models Method

As proposed, HCIs that have qualified to use the IMM, and are therefore currently using this approach to measure counterparty exposures for the sake of the HCI scorecard, would be required to stop using IMM for this purpose beginning in first quarter 2015. **ABA recommends that an HCI that is authorized to use IMM for capital purposes should continue to be allowed to use IMM to measure counterparty exposures for the HCI scorecard.**[22]

Use of IMM is permitted in the United States and globally in Basel Committee nations specifically because it is seen as the most accurate method to measure actual risk. Any institution seeking to use IMM must go through a rigorous and expensive qualification process to develop risk management and measurement systems according to the Basel Advanced Approaches. This process includes at least a four-quarter "parallel run" where the institution must demonstrate that its Advanced Approaches models are effective and measure risk exposure more accurately than the fixed formulas under the Standardized Approach. Qualification is subject to intense scrutiny from the institution's primary supervisors. The Federal banking agencies in the United States took the qualification process very seriously, forcing applicant institutions to go through, not four quarters, but instead several years of rigorous review before allowing eight to exit "parallel runs" and start using Advanced Approaches models in second quarter 2014.

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[19] 12 CFR §3.32(c)(3), §217.32(c)(3) and §324.32(c)(3).

[20] FDIC, Federal Reserve System and Office of the Comptroller of the Currency, *Liquidity Coverage Ratio: Liquidity Risk Measurement Standards*, September 3, 2014, www.fdic.gov/news/board/2014/2014-09-03_notice_dis_b_fr.pdf.

[21] *Ibid*, page 66.

[22] We note that IMM is permitted in other regulatory contexts; banks can use IMM to measure derivative exposure and securities financing transition exposure for purposes of the national bank lending limit. (12 CFR §32.9(b)(1)(i) and §32.9(c)(1)(i))

However, even after an institution has persevered through this demanding review process, it has not necessarily qualified to use IMM; there is even a further qualification process for that. As noted in the proposal, some of the HCIs have not qualified to use the IMM.[23]

This extensive qualification process certifies IMM as the bank's most reliable measurement of risk exposure. As such, the IMM, when certified by supervisors, produces measures of counterparty risk exposure that, when applied to the HCI scorecard, are consistent with the statutory requirement for FDIC assessments to be tied to risk exposure for individual banks and therefore to the insurance fund.

The proposal cites as a basis for invalidating use of IMM that it will lead to significant reductions in reported counterparty exposure measures, and corresponding reductions in assessments, and that "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."[24] However, this same point argues against the proposed change: Use of IMM is currently permitted in the HCI scorecard, and some banks are currently qualified to use it. Therefore, the proposed elimination of this method would lead to significant increases in reported counterparty exposure measures for these institutions, and corresponding increases in their assessments, but this significant increase in assessments would not be driven by a change in risk exposure.

The key point should not be whether individual banks' assessments would rise or fall; it should be about whether a measure of counterparty exposure is consistent with statute – *i.e.*, the requirement for the HCI scorecard measures to correlate with risk to the insurance fund. Further, a significant reduction in assessments under IMM may not be driven by a change in risk exposure, but instead by more accurate measurement of risk exposure. If a bank's assessments decline in moving to a more accurate system, this would mean that the bank has been paying excess assessments due to less accurate measurement of risk.

As proposed, HCIs would be required to use the "credit equivalent amount" (CEA) under the Basel III Standardized Approach to measure credit counterparty exposure.[25] The shortcomings of this measure of counterparty exposure are well known and have been widely recognized,[26] as reflected in the Basel Committee's development of an alternative approach to measuring

[23] Proposal, page 42703.
[24] Proposal, page 42703.
[25] The proposal requests also comment on whether "total leverage exposure" should be used to measure counterparty exposure. The logic of a leverage measure is that it is not risk-based, and thus can serve as a backstop to risk-based measures in an unusual market. (Basel Committee on Banking Supervision, *Basel III: a Global Regulatory Framework for More Resilient Banks and Banking Systems*, June 2011, ¶152, www.bis.org/publ/bcbs189.pdf.) The fact that a total leverage measure is not risk-based makes it inappropriate for the HCI scorecard.
[26] See Basel Committee on Banking Supervision, *The Standardised Approach for Measuring Counterparty Credit Risk Exposures,* March 2014, www.bis.org/publ/bcbs279.pdf, page 1.

counterparty credit risk for derivative exposures, the SA-CCR.[27] There is no comparison in the proposal to IMM as a measure of risk exposure; nor is there a demonstration that the CEA is consistent with the statutory mandate for assessments to be based on risk exposure.

The justification proffered in the proposal for adoption of the CEA is that "all banks employing the highly complex institution scorecard would calculate their counterparty exposure using a common measurement framework. Using a common, consistent methodology for measuring counterparty exposure would ensure that methodological differences do not determine a bank's exposure relative to its peers."[28] While consistency of application is clearly desirable, this objective is not codified in statute. As noted, the statutory requirement is for the HCI scorecard to be based on risk exposure to the insurance fund. The *a priori* assumption unless proven wrong is that that IMM measurement most closely aligns with this requirement for banks that qualify to use IMM. If certain HCIs choose to go through the rigor and expense of adopting IMM, the results should not be discarded because other HCIs have not.

We also note that adoption of the Standardized Approach CEA for purposes of the HCI scorecard is premature. The Basel Committee recently finalized the SA-CCR, which is designed to replace the CEA methodology within the Basel III framework. In adopting Basel III, the Federal banking agencies acknowledged the ongoing work of the Basel Committee to improve the current exposure methodology and "expect to consider any necessary changes to update the exposure amount calculation when the [Basel Committee's] work [is] completed."[29] Given the release of the final SA-CCR, the IMM option should not be eliminated before the agencies determine whether and how to incorporate the SA-CCR into Basel III in this country.

Recalibration of the Scorecard

As proposed, the FDIC reserves the right to recalibrate the HCI scorecard after changing the way that counterparty exposure is measured.[30] **Considering the uncertainties regarding the procedure for setting cut-offs for the counterparty exposure measures and the potential magnitude of effect on some banks assessments, ABA requests that any recalibration following a change in the counterparty exposure measure go through the public-notice-and comment process.**

The FDIC has stated that it would go through public notice and comment before changing the methodology for selecting cut-offs, as opposed to adjusting the cut-offs themselves using the pre-established methodology.[31] However, there is little distinction between altering the cut-offs and

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[27] Basel Committee on Banking Supervision, *The Standardised Approach for Measuring Counterparty Credit Risk Exposures,* March 2014, *www.bis.org/publ/bcbs279.pdf*. The SA-CCR will replace both the Current Exposure and Standardized Methods as a new framework calculate potential future exposure.

[28] Proposal, pages 42703-42704.

[29] 78 Federal Register 55340, September 10, 2013, at 55412; 78 Federal Register 62018, October 11, 2013, at 62094.

[30] Page 42704 in the proposal, following the authority provided for in 76 Federal Register 10672, February 25, 2011, at 10700 and 77 Federal Register 66000, October 31, 2012 at 66004-66005.

[31] 76 Federal Register 10672, February 25, 2011, at 10700.

the methodology to do so when unspecified measures, such as "recent experience," are used in place of data. We note that a different, and ambiguous, procedure is used to set cut-offs for the counterparty exposure measures in the HCI scorecard, as compared to other scorecard components.[32] The lack of transparency in this process, which can have a major effect on the assessments paid by individual HCIs, suggests that affected institutions and the public should have a chance to review and respond before any change in exposure measure is implemented.

In the past, the FDIC has acknowledged that "[i]f, as a result of its review and analysis, the FDIC concludes that measures should be used to determine risk-based assessments, that the method of additional or alternative selecting cutoff values should be revised, that the weights assigned to the scorecard measures should be recalibrated, or that a new method should be used to differentiate risk among large institutions or highly complex institutions, changes will be made through a future rulemaking."[33] ABA suggests that recalibration following a change in the counterparty exposure measure used in the HCI scorecard is consistent with this list and would warrant allowing institutions to see and comment before the change is finalized.

[32] Minimum and maximum cut-off values for components of the scorecard are generally set at the 10th and 90th percentile levels over ten years of historical data for affected banks. However, cut-offs for the "largest counterparty exposure/tier 1 capital and reserves" and "top 20 counterparty exposure/tier 1 capital and reserves" are instead based partly on "recent experience" with the maximum ranging from the 75th through 78th percentile of values for HCIs. The difference is due to a lack of historical data and the fact that there is no concentration measure (which includes the counterparty exposure measures) in the scorecard for non-HCI banks subject to Large Bank Pricing. (76 Federal Register 10672, February 25, 2011, at 10695)

[33] 76 Federal Register at 10672, February 25, 2011, at 10700

Assessment Base Calculation for Custodial Banks

Currently a bank that qualifies as a "custodial bank"[34] can deduct from its assessment base a portion of certain liquid assets (custodial assets).[35] The portion deducted is 100 percent of custodial assets that are risk weighted at 0 percent under the existing ("Basel I") risk-based capital rules plus 50 percent of those risk weighted at 20 percent. However, the deduction is capped at the amount of custodial deposits.

The proposal would roughly incorporate elements from the Basel III Standardized Approach rules that will go into effect next year to limit this deduction in two ways:

- A transaction that clears through a QCCP has a 0 percent risk weight under existing capital rules but would be risk-weighted at either 2 percent or 4 percent (depending on the type of transaction) under Basel III. Accordingly, only half of the balance of this type of asset would be deductible.
- No deduction would be allowed for an asset that qualifies as a "securitization exposure."[36]

Securitized Assets

As proposed, any securitization – broadly defined to include any credit exposure where there are underlying exposures with different levels of seniority – would no longer qualify for any deduction, regardless of whether its Basel III risk weight is no more than 20 percent. The proposal's justification is that a custodial bank "need[s] to hold low-risk, liquid assets to facilitate the payments and processing function associated with its custody and safekeeping accounts. For this reason, the FDIC is proposing to exclude from the assessment base deduction those asset types … that qualify as a securitization exposure … since these assets are often not liquid."[37]

The FDIC should recognize that holding securitized assets is essential to, and sound practice for, custodial banks. Custody deposits are the primary building block of a custody bank's balance sheet and represent the residual operational cash of institutional investor clients resulting from the provision of safekeeping and asset administration services. Custody banks invest these funds in well-diversified portfolios of high-quality and suitably liquid assets – including securitized

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[34] The FDIC defines a "custodial bank" for these purposes as one with $50 billion or more of custody and safekeeping assets or else derived more than half of its revenue from custody and safekeeping activities. (76 Federal Register 10672, February 25, 2011, at 10706)

[35] Balances reported under lines 34–37 on Call Report Schedule RC-O count as "custodial assets." These balances are for cash and balances due from depository institutions, securities (held-to-maturity and available-for-sale), federal funds sold, and securities under agreements to resell.

[36] "Securitization exposure" is defined here as an on- or off-balance sheet credit exposure (including credit-enhancing representations and warranties) that arises from a traditional or synthetic securitization (or re-securitization), or an exposure that directly or indirectly references a securitization exposure. Traditional collateralized mortgage obligations issued or guaranteed by the GSEs that do not have credit tranches generally do not meet this definition. (Proposal, footnote 32 on page 42702)

[37] Proposal, page 42702.

assets. The banks actively monitor and manage the credit quality and structural liquidity of these investments, using prudent and proven risk management practices. These practices are closely monitored by supervisors to be consistent with the *Interagency Policy Statement on Funding and Liquidity Risk Management*.[38]

The proposal's assertion that all securitization exposures are "often not liquid" is contradicted by actual experience and fails to recognize the credit and liquidity value of high-quality securitizations. Moreover, by excluding securitizations, the proposal fails to account for the asset-liability management practices of custody banks. Securitizations are well-established investment structures that provide access to various forms of financing, as well as diversification and management of risk. They are pooled investment vehicles backed by financial assets, such as mortgages, credit cards, auto loans, government guaranteed and private student loans, and commercial mortgages. Consequently, securitizations benefit from stable, predictable cash flows and are fully secured by the underlying loan receivables.

Unlike other highly-rated assets, such as investment-grade corporate bonds, securitizations also benefit from a series of credit enhancements that mitigate risk. This includes the use of a "tranche" structure with a senior class of securities and at least one additional subordinate class. The subordinate classes absorb the first losses incurred in the loan portfolio, thus protecting more senior tranches from losses.

Due to their stable credit profile, high-quality securitizations enjoy strong liquidity and broad acceptance among institutional investors. According to industry data, there are $2.1 trillion in outstanding asset-backed securities (ABS) and commercial mortgage-backed securities (CMBS), and new issuances are on pace to reach $280 million this year.[39] This is roughly half the size of the U.S. agency mortgage-backed securities market, which is broadly recognized as one of the most liquid fixed income markets in the world (along with a handful of sovereign debt markets). Securitized products, including ABS and CMBS, comprise nearly one-third of the Barclays Aggregate Bond Index by market value, ensuring broad investor participation.

Furthermore, securitizations benefit from robust secondary market liquidity. For example, the daily trading volume through August of this year has averaged $1.1 billion for ABS, $0.3 billion for CDOs, and $1.9 billion for CMBS.[40] Transaction bid-ask spreads range only 2-to-5 basis points in a normal trading environment. As a result, most high-quality securitizations can be monetized in the private market, through either secured funding or outright sale, and therefore represent a stable source of structural liquidity. Moreover, most high-quality securitizations are eligible collateral in the U.S. and other central bank operations, and can therefore be monetized in the normal course discount window transactions.

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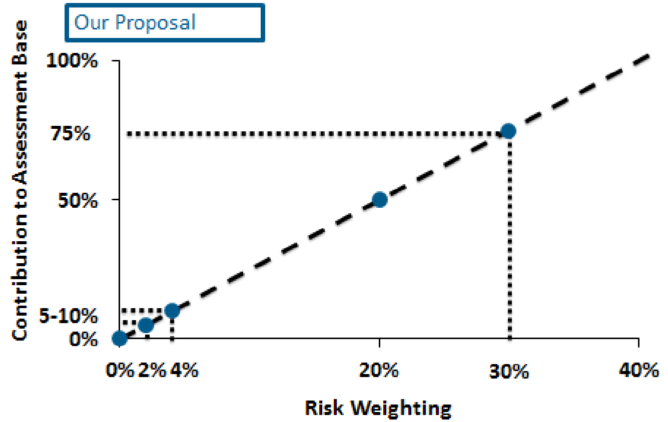
[38] FDIC, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision, Interagency Policy Statement on Funding and Liquidity Risk Management, March 17, 2010, www.federalreserve.gov/boarddocs/srletters/2010/sr1006a1.pdf.

[39] Based on data from the Securities Industry and Financial Markets Association posted to www.sifma.org/research/statistics.aspx.

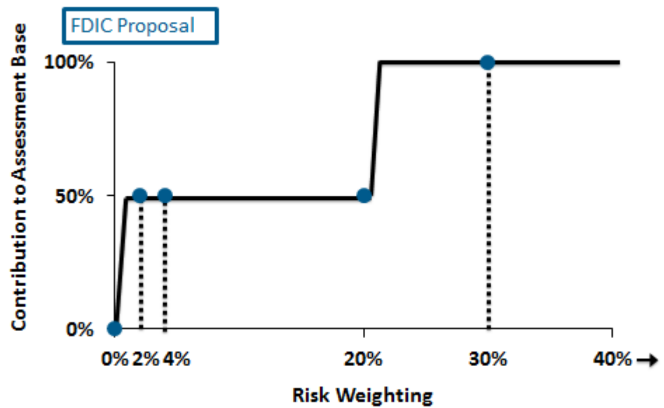
[40] *Ibid*.

In sum, it is entirely reasonable and appropriate for custody banks to invest in securitized assets as an integral part of the safekeeping and asset administration services offered to their institutional investor clients. Accordingly, the final rule should remove blanket exclusion of securitized assets from the scope of the custody bank adjustment. **Assuming that a securitized asset meets standards prescribed by the FDIC for determining high-quality, low-risk securities, it should be eligible for inclusion within the assessment base deduction.**



Alternate Weighting Scheme

As proposed, any "custodial asset" that is cleared through a QCCP – currently 100 percent deductible from the assessment base – would become only 50 percent deductible despite a minimal increase in measured risk (as gauged under federal rules). The reasoning proffered in the proposal is that, while cleared transactions "are generally liquid and low-risk, they are not risk-free and consequently do not merit a 100 percent inclusion in the assessment base deduction for custodial banks."[41]



This approach unfairly punishes assets with marginally higher risk weights with jumps in the deduction limit. Cleared transactions – with a 2 percent or 4 percent risk weight – would be treated the same as assets with a 20 percent risk weight. A securitization whose risk weight may increase by no more than 1 percent would be treated as if it held a high risk weighting.

While it is reasonable to incorporate updated risk weightings from Basel III, the proposal would go only part way. An alternate approach would be to leverage the additional detail of the new standard to better capture the credit profile of deductible assets.

The FDIC has already established a relationship between risk weighting and the custodial asset deduction that it deems appropriate. It makes sense then to apply this same relationship to all

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[41] Proposal, page 42702.

assets that qualify for a deduction. Accordingly, **a more suitable deduction rule would be that the deduction for a qualifying asset (with a risk weight from 0 to 40 percent) equals 100 percent minus 2½ times its Basel III Standardized Approach risk weight.**

What this alternate approach does, and the proposal does not, is take into account the marginal risk of assets with 2 percent and 4 percent risk weights. As the proposal notes, these assets "are generally liquid and low-risk, they are not risk-free and consequently do not merit a 100 percent inclusion in the assessment base deduction for custodial banks." To be fair, the minimal risk of these assets warrants 95 percent and 90 percent deductibility, respectively.

Basel III	Asset Deduction	
Risk Weight	Proposed	Alternate
0%	100%	100%
2%	50%	95%
4%	50%	90%
20%	50%	50%
35%	0%	12%
40%	0%	0%

Moreover, high-quality, high-priority tranches of securitizations would not suddenly totally disqualify as deductions due to a small increase in risk weighting. Instead, the deduction would be as low as 50 percent, just as before, only for the very safest tranches – as measured under Basel III – and would decline steeply and proportionately with the tranche priority.

Note that only assets that are currently eligible for deduction would qualify for deduction under the alternate plan, and that the alternate plan would still reduce the deductibility of eligible assets with higher risk weights.

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ABA appreciates the opportunity to share our views. Thank you for taking the time to consider them. The undersigned would be pleased to discuss any point in this letter at your convenience.

Sincerely,

Robert W Strand

Robert W. Strand