

September 20, 2017

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

The Honorable Janet L. Yellen
Chair
Board of Governors of the Federal Reserve System
Eccles Board Building
20th and C Street, N.W.
Washington, D.C. 20219

Mr. Keith Noreika
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, S.W.
Washington, D.C. 20219

Re: Changes to U.S. Regulatory Capital Framework; Pause in Basel III Transition Periods

Dear Chairman Gruenberg, Chair Yellen, and Acting Comptroller Noreika:

The American Bankers Association¹ (ABA) supports the Agencies' proposal to pause the Basel III transition period (Transition Proposal) to facilitate the proposal, review, and promulgation of amendments to the risk-based capital standards to address certain problems that needlessly inhibit economic growth. The Basel III capital rule, which was finalized in 2013, included a multi-year transition period that phases in certain aspects of the rule. During the transition period banks must phase in the deduction requirement for the amounts of Mortgage Servicing Assets (MSAs), timing differences on Deferred Tax Assets (DTAs), holdings of regulatory capital instruments issued by financial institutions that exceed 10 percent of common equity, and certain minority interests. These deductions are currently taken at 80% of the full amount and are scheduled to be fully phased in by 2018.

¹ The American Bankers Association is the voice of the nation's \$17 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard \$13 trillion in deposits and extend more than \$9 trillion in loans.

As we wrote in June,² ABA is concerned that these deductions could be fully phased in before the agencies have finalized the rulemakings highlighted in the Agencies' joint report³ to Congress as required by the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA). As part of the EGRPRA report, the Agencies stated that

[T]he regulatory capital rules are too complex given community banks' size, risk profile, condition, and complexity. The agencies therefore are developing a proposal to simplify the regulatory capital rules in a manner that maintains safety and soundness and the quality and quantity of regulatory capital in the banking system.

The EGRPRA report further states that “amendments likely would include... simplifying the current regulatory capital treatment for MSAs, timing difference DTAs, and holdings of regulatory capital instruments issued by financial institutions and simplifying the current limitations on minority interests in regulatory capital.”

ABA supports both the intentions expressed in the EGRPRA report and in the Transition Proposal freezing Basel III implementation. We share the view that regulatory capital standards are more complex than necessary to achieve their prudential supervisory purpose, and we are pleased that the Agencies are considering simplification efforts. This is an appropriate time to consider the effectiveness of prudential supervision standards implemented in recent years, with a view toward simplifications and improvements that will not compromise safety and soundness. In light of the Agencies' announced active consideration of amending the capital treatment of these exposures, ABA believes it is appropriate to freeze the current transition period for all banks until rules reducing unneeded complexity are proposed and finalized.

I. Response to questions in proposal.

a. What, if any, operational or administrative challenges would the proposed changes in this transitions NPR pose to banking organizations? What, if any, alternatives should the agencies consider to address such challenges?

ABA does not anticipate significant operational or administrative challenges should the Transition Proposal be finalized. We note that the proposal indicates that the Agencies would revisit the call report instructions and stress testing templates should the Transition Proposal be finalized. We believe this would be a necessary step to set clear expectations.

² Letter from ABA to the Agencies requesting a freeze of Basel III implementation period dated June 20, 2017, available at: <https://www.aba.com/Advocacy/LetterstoCongress/Documents/Changes-to-US-Regulatory-Capital-Framework-06202017.pdf>.

³ Joint report available at: https://www.ffiec.gov/pdf/2017_FFIEC_EGRPRA_Joint-Report_to_Congress.pdf.

b. What, if any, modifications should the agencies consider making to the scope of application of this proposal?

The scope of the Transition Proposal is limited to non-Advanced Approaches banking organizations. This limitation is unnecessary. Simplification of the regulatory capital standards under consideration is important for all banking organizations, regardless of size.

ABA recognizes the Transition Proposal, and the indicated EGRPRA amendments, as important steps in simplifying the regulatory capital standards in general, which suffer from more complexity than is necessary, inhibiting their value for supervisory purposes as well as for bank management. In that context we believe that the Agencies' efforts to simplify the regulatory capital standards should embrace more than the limited amendments promised in the EGRPRA report. That may require several iterations of review of the body of capital standards and of proposed amendment to provide the careful consideration and adjustment that would be warranted. The benefits along the way, though, would be increased facilitation of economic growth. The Transition Proposal supports a logical place to begin this work.

Regulatory capital is currently measured in too many ways for proficient bank supervision and management. Regulations pursuant to the 1988 the Basel Capital Accord (Basel I) contained two risk-based capital ratios, composed of two tiers of capital (Tier 1 and Tier 2). As part of the risk-based framework, the U.S. also maintained a GAAP based leverage ratio (a risk-blind measure) to address unknown or unpredictable risks. As a result, at the end of the Twentieth Century U.S. banks were subject to three regulatory capital ratios. Today, there are at least eight basic regulatory capital ratios applied in the United States, to which are added a variety of permutations generated by requirements for various minimums, buffers, and surcharges.

Section 171 of the Dodd-Frank Act establishes a Basel I risk-based capital floor for banks operating under the Basel II models-based framework. These institutions must meet three risk-based capital ratios using Basel II methodologies as well as three risk-based capital ratios using Basel I methodologies.

This duplicative work would be further complicated by the most recent round of Basel Committee proposals (Basel IV). The announced goal of these proposals is to "simplify" the Basel capital standards by establishing yet another series of risk-based capital ratios. For U.S. banks, as ABA has discussed,⁴ this recent Basel Committee simplification effort has raised the possibility of internationally active U.S. banks being permanently subject to nine measures of risk-based capital, including two risk-based capital floors simultaneously,⁵ as well as applicable leverage ratios.

⁴ Letter available at:

<https://www.aba.com/Advocacy/commentletters/Documents/PossibleChangestotheUSCapitalFramework.pdf>.

⁵ The first, which is applied as a result of provisions contained in the Dodd-Frank Act, has the current U.S. Standardized Approach acting as a floor to the Advanced Approaches risk-based capital standard. The second would be the Basel Committee's Revised Standardized Approach, should it be finalized.

To facilitate efforts to simplify the regulatory capital standards for all banks, ABA urges the Agencies to finalize the Transition Proposal promptly, with an expanded scope to cover all banks.

ABA disagrees with the underlying assumption contained in the Transition Proposal, wherein generally applicable capital standards—for the capital treatment for the same assets—would differ solely depending on the size of the bank holding those assets, without any case being made that the provisions needing amendment make any more sense for larger banks than for other banks. Creating different definitions of capital for the issues under consideration solely on the grounds of size is not justified. For example, the improper treatment of mortgage servicing assets in the current Basel III implementing rules does not become more proper when a bank becomes larger. The harm to customers, banks, and the economy occurs regardless of the size of the bank. The Proposal, however, by drawing these unjustifiable lines would add unnecessary complexity to the overall framework. Comparing institutions, particularly those near the \$250 billion threshold used to designate Advanced Approaches banks, could become even more complex and confusing.

II. Treatment of MSAs, DTAs, and holdings of regulatory capital instruments issued by financial institutions.

a. Eliminate the aggregate 15 percent deduction threshold.

The deduction provisions contained in the Basel III final rule are among the more complex aspects of a complex rule. Generally, the provisions require “threshold deductions” for individual asset classes set at 10% of common equity tier 1 (CET1) as well as “aggregate deduction thresholds” for various groups of assets set at 15% CET1. The combination of individual and aggregate deduction thresholds is unnecessarily complex and unwieldy. For example, the final rule includes a sixteen box flow chart for the treatment of investments in the capital of unconsolidated financial institutions. Such complexity offers little value for supervision or for bank management. ABA urges the Agencies to eliminate the 15% aggregate deduction threshold.

b. Raise the MSA deduction threshold to at least twenty five percent.

As outlined in ABA’s Capital White Paper published in April 2017,⁶ servicing mortgage loans is a specialty of many banks and has long provided a strong source of stabilizing fee income. Mortgage servicing is an important way to maintain valuable long-term customer relationships, while allowing the bank to sell a long term asset to manage its interest rate risk. As a result of the punitive capital treatment under Basel III, we have seen mortgage servicing assets migrate to

⁶ White Paper available at: <https://www.aba.com/Advocacy/Issues/Documents/ABA-White-Paper-Regulatory-Capital-Standards.pdf>.

non-bank mortgage servicers at an accelerated rate, a shift in market share that we do not believe was intended by the Agencies. Banks have strong incentives to be good mortgage servicers because of the importance of their long-term customer relationships. The forced shift of mortgage servicing from banks to non-banks has not overall been a happy one for customers. Customers and the banks that serve them well should not be penalized by the punitive treatment of MSAs under the current capital rules.

We recommend that, as a minimum reform, the MSA deduction threshold be increased from 10% to at least 25% of CET1. A 25% deduction, although still a significant restriction compared to previous capital treatment, would lessen the disruption to customers and the relationships they have chosen to build with their bank. Moreover, for the portion of MSAs that are not deducted, we believe the risk weight should be set at no higher than 100%.

c. Investments in the capital instruments of unconsolidated financial institutions.

- i. Eliminate the distinction between “significant investments” and “non-significant investments” in the capital of unconsolidated financial institutions and raise the deduction threshold of the combined category to twenty five percent.*

As indicated above, the treatment of investments in the capital of unconsolidated financial institutions is extremely complex, requiring a sixteen box flow chart to determine the appropriate capital treatment. Part of this complexity stems from the distinction between “non-significant investments” and “significant investments,” each of which is subject to a 10% deduction threshold. In order to simplify the rules, this distinction and the 10% deduction threshold should be eliminated. Non-significant investments and significant investments in unconsolidated financial institutions should be pooled together and subject to a 25% deduction threshold. The Agencies should also consider further increases in the financial institution deduction threshold should the Agencies expand the types of assets subject to the deduction threshold (such as Total Loss Absorbing Capacity (TLAC) funds).⁷

⁷ The preamble of the TLAC final rule states:

The final rule does not adopt the requirement in the proposal that state member banks, bank holding companies, and savings and loan holding companies and IHCs formed to comply with the Board’s enhanced prudential standards for foreign banking organizations deduct investments in the unsecured debt of covered BHCs that exceed certain thresholds from regulatory capital. The Board intends to address these elements of the proposal jointly with the Office of the Comptroller of the Currency (OCC) and FDIC at a later time, in order to apply these requirements consistently to all entities subject to the regulatory capital requirements of the federal banking agencies.

ii. *Grandfather the capital treatment of TruPS investments.*

As outlined in ABA’s Capital White Paper published in April 2017,⁸ existing TruPS held by banks as investments should not be subject to the Basel capital deduction. Trust Preferred Securities (TruPS) collateralized debt obligations (CDOs) provided a means for smaller banking organizations to access capital/debt markets by issuing TruPS that were pooled into CDOs. In practice, TruPS could absorb losses when an individual bank was in difficulty, but it turns out that they tended to generate losses when the entire market was in decline. For those reasons, the Dodd-Frank Act (DFA) ended the recognition of TruPS for capital purposes going forward but grandfathered existing TruPS investments to permit them to mature and thus avoid retroactively harming community bank capital positions.

Banking organizations can also be *investors* in TruPS. However, despite the express grandfather treatment under the DFA for issuers of TruPS, investors in TruPS must take deductions under the Basel III capital rules if held in excess of 10% of CET1.

The Agencies have maintained the deduction for TruPS even though they have acknowledged that the congressional intent of the Dodd-Frank Act was to maintain the “status quo” for the TruPS market, allowing them to be held to maturity. In recent *Volcker Rule* guidance, the Agencies expressly cite this congressional intent to provide relief for bank investors in TruPS instruments, yet fail to honor this intent in the *capital rules* for banks investing in TruPS. This unnecessarily punishes the capital position of these banks. This is in spite of the fact that these investments are written down to reflect all past and projected issuer defaults in accordance with accounting rules.

ABA urges the Agencies to exclude existing TruPS held by banks from deduction from capital. We believe the deduction for TruPS CDO investments held by a bank is unwarranted and fails to honor congressional intent to grandfather these investments.

d. Raise the DTA deduction threshold to reflect changes to accounting standards.

The Financial Accounting Standards Board’s Current Expected Credit Loss (CECL) impairment standard poses significant compliance and operational challenges for banks. Issued in June 2016, and set to take effect in 2020 for SEC registrants (2021 for all other banks), the new standard represents arguably the most sweeping change to bank accounting ever. Although ABA is continuing to review the standard and its potential impact on regulatory capital, we believe there may be an increase in DTAs resulting from timing differences. As a result, we encourage the banking agencies to examine this possibility and raise the DTA deduction threshold as needed.

⁸ White Paper available at: <https://www.aba.com/Advocacy/Issues/Documents/ABA-White-Paper-Regulatory-Capital-Standards.pdf>.

III. Other amendments to the generally applicable capital rules.

In addition to the asset classes affected by the Transition Proposal, the Agencies should also consider other amendments to the generally applicable capital standards.

a. High Volatility Commercial Real Estate.

The Basel III final rule applies a 150% risk weight to High Volatility Commercial Real Estate (HVCRE). To be exempted from this burdensome HVCRE designation, borrowers who originate commercial acquisition, development and construction (ADC) loans must meet a 15% equity requirement, and the leverage on such loans cannot exceed 80% of the estimated completed value of the project. Bankers generally seek to avoid the HVCRE designation because of the higher capital requirement, but the regulation is extremely difficult to apply. The impact to originators and customers is heightened uncertainty and unpredictability with regard to pricing and feasibility of any particular transaction.

The Agencies should formally publish a proposal that provides for a lower HVCRE risk weight and sets clear criteria that track appropriate risk drivers for determining whether an ADC loan should be designated as HVCRE.

b. Unrealized Gains and Losses.

Banks subject to the Advanced Approaches risk-based capital standards are required to “flow through” to CET1 all unrealized gains and losses from a banking organization’s available for sale (AFS) portfolio. ABA in general opposes different definitions of capital based on bank asset size. We have not been able to identify the logic of applying this rule to larger banks, even though it is wisely not applied to the rest of the industry. In either case, regardless of bank size, it is a standard that introduces meaningless volatility into capital calculations.

Inclusion of unrealized gains/losses in capital is bad policy; by imposing purposeless volatility, unrelated to the actual health of a bank, it also undermines prudent risk management. It penalizes Advanced Approaches banks for holding high-quality liquid assets (HQLA), which penalty is inconsistent with applicable liquidity rules that require banks to hold significant amounts of HQLA. Volatility in a bank’s capital account adds volatility to the broader economy, to some degree reducing the important role that banks play in moderating the ups and downs of the business cycle. Volatility in a bank’s capital account, unrelated to the bank’s performance, introduces volatility into the bank’s provision of financial services.

This is not imagined. In recent quarters, AOCI has introduced significant penalties and bonuses into bank capital measurements. In the second quarter of 2017, that AOCI capital requirement resulted in bank capital increasing by \$8 billion, following a \$3.3 billion increase in Q1 2017, versus a devaluation in bank capital of \$39.5 billion in Q4 2016, a \$3.7 billion hit in Q3, an increase of \$10 billion Q2 2016, while in Q4 of 2015 banks again lost \$13.5 billion to capital from AOCI—all unrelated to the actual financial condition of the banking industry. This is not sound bank supervision.

The debt securities generally held in AFS portfolios are highly liquid bonds, such as U.S. Treasuries, the sale value of which is primarily impacted by changes in interest rates. Therefore, in a rising rate environment, the value of those securities will decrease, creating a generally unrealized loss reflected in a bank's AFS portfolio that is typically temporary in nature but never realized if a bank holds the securities to maturity. In a declining rate environment, bank capital accounts will be artificially boosted by the AOCI calculation. To take into account the volatility introduced into capital calculations, Advanced Approaches banks now hold "volatility buffers" above any set regulatory capital levels.

We urge the agencies to amend the Basel III capital rules so that unrealized gains and losses (AOCI) are not included in any banking organization's capital calculation, no matter the size of the institution.

c. Treatment of Subchapter S Banks.

The capital conservation buffer provisions of the Basel III capital rules seriously and inappropriately disadvantage some 2,000 U.S. community banks that have elected Subchapter S Corporation tax status (S Corp banks). Under the Subchapter S rules, shareholders are required to pay federal income taxes on a firm's profits proportionate to the shareholders' ownership interest in the company—regardless of whether profits are actually distributed to the shareholders. Generally, shareholders in S Corp banks are able to meet their tax obligations from distributions they receive from their S Corp bank. However, under the Basel III capital conservation buffer requirements, a bank may be limited or prohibited from making distributions if the bank's capital levels fall below the required capital buffer, even though the bank is profitable and prosperous enough to incur a tax liability. In such a case, the tax obligation would remain, forcing the bank's shareholders to pay taxes on income that Basel III capital rules prevent them from receiving. The possibility of that treatment places the S Corp bank at a competitive disadvantage to C Corp institutions in attracting investors.

ABA urges the Agencies to amend Basel III to allow S Corp banks to make distributions for the limited purpose of allowing shareholders to make tax payments on their share of the S Corp bank's undistributed income in an amount comparable to the effective tax rate for C Corps.

d. Revised Methodology for Securities Financing Transactions (SFTs).

The generally applicable capital rules use the risk-insensitive haircut-based "Collateral Haircuts Approach" for the measurement of exposures to SFTs, including repurchase agreements, reverse repurchase agreements, securities lending and borrowing transactions, and eligible margin loans. Under this approach, exposures can be reduced by eligible financial collateral. However, banking organizations must decrease the value of the collateral received and increase the value of the securities posted by a series of pre-determined market volatility haircuts. Foreign exchange volatility haircuts also apply to any differences in currency.

This approach suffers from several shortcomings. First, the approach implicitly assumes that for every trade, each security posted as collateral increases in value while each security received as collateral decreases in value, and that the impact of foreign exchange movements is always

negative. Second, this approach ignores the effect of portfolio diversification in the distribution of risk, assuming at all times that securities issuances will move in a perfectly correlated manner. Third, the approach provides for very limited opportunities to net transactions, which is only allowed at the level of the individual security. This results in an exposure measure that is highly risk-insensitive and multiples higher than the “maximum possible loss” that a bank could incur.

The revised methodology for SFTs proposed by the Basel Committee⁹ goes a long way towards addressing these concerns. This methodology includes changes which permit the netting of loans and offsetting collateral by counterparty, the use of a factor to approximate correlation on a market-wide basis, and the use of a factor to approximate the impact of portfolio diversification. While the proposed methodology remains conservative, with exposure amounts that are 7x to 10x greater than exposure amounts using simple value-at-risk methodologies, these outcomes are a significant improvement over the prevailing “Comprehensive Approach” and therefore warrant inclusion as an option under the generally applicable capital rules.

ABA encourages the Agencies to propose the revised methodology for SFTs proposed by the Basel Committee *as an option* under the generally applicable capital rules for all banks.

e. Revised Treatment of Securities Firms.

The application of a 100% risk weight for exposures to broker-dealers and securities firms within the generally applicable capital rules is disproportionate relative to the risk weights for other prudentially regulated financial institutions. On a global basis, many regulators mandate stand-alone capital requirements for broker-dealers that are broadly equivalent to Basel standards; they also often impose other regulatory constraints, such as liquidity requirements and the segregation of client assets. Many broker-dealers are also subsidiaries of prudentially regulated bank holding companies. Given that the regulatory regimes for broker-dealers are similar to those for banking organizations these exposures should be less risky than exposures to general corporates.

The Basel Committee’s proposed revised standardized approach¹⁰ recognizes these safeguards and applies lower risk weights to securities firms, including broker-dealers consolidated into a banking holding company, that are “subject to prudential standards and a level of supervision equivalent to those applied to banks...”¹¹ We urge the Agencies to align the risk weights for registered broker-dealers and securities firms to those that apply to banking organizations and amend the generally applicable capital rules.

⁹ Consultative document available at: <http://www.bis.org/press/p151210.htm>.

¹⁰ *Id.*

¹¹ Paragraph 30 of the Proposed Revised Standardized Approach.

f. Client Clearing Under the Generally Applicable Capital Standards.

The original U.S. Basel III rules, when adopted in 2013, prescribed different risk-weights for agency and financial intermediary client clearing arrangements.¹² In an agency structure, the Clearing Member (CM) bank assigns an Over the Counter (OTC) risk-weight to its client-facing exposure, but the CM bank is deemed to have no (Central Counter Party) CCP-facing exposure. In a financial intermediary structure, the CM bank assigns an OTC risk-weight to its client-facing exposure and a cleared transaction risk-weight (generally, 2%) to its CCP-facing exposure. As a result, CM banks will have higher risk-weighted assets when operating in financial intermediary structures, even when the risk profile is equivalent to agency arrangements.

The Agencies recognized this anomaly and adopted a final rule in 2015 to correct the disproportionately punitive treatment of financial intermediary structures in the U.S. Basel III Advanced Approaches. Under the 2015 final rule, a CM bank in a financial intermediary structure may apply a 0% risk-weight to its CCP-facing exposure when the CM bank “is not obligated to reimburse the clearing member client in the event of the CCP default.”¹³ When adopting this amendment, the Agencies noted that “requiring the clearing member banking organization to include in risk-weighted assets a trade exposure amount for the client-cleared transactions could overstate the clearing member’s risk where the clearing member is not contractually obligated to perform on the transaction to its client in the event of a CCP failure.”¹⁴ Within U.S. Basel III Advanced Approaches, the 2015 amendment leads to equivalent risk-weighted assets between agency and financial intermediary structures when risks are equivalent.

The 2015 amendments, however, did not modify the generally applicable capital standards (i.e. U.S. Basel III Standardized Approach).¹⁵ The Agencies noted, in the 2015 amendment preamble, that commenters had requested that “the proposed changes should apply to the standardized approach,” but that the Banking Agencies “did not seek comment on revisions to the provisions in the standardized approach, and banking organizations subject to the standardized approach but not to the advanced approaches rule may not have had sufficient notice of the change.”¹⁶ The Agencies concluded by noting that they “will consider the suggested change in the context of future proposed rulemakings.”¹⁷

¹² See 78 Fed. Reg. at 62,100-03 (Oct. 11, 2013)

¹³ 12 C.F.R. § 3.133(c)(3)(iii) (as revised per 2015 amendment); 12 C.F.R. § 217.133(c)(3)(iii) (as revised per 2015 amendment); 12 C.F.R. § 324.133(c)(3)(iii) (as revised per 2015 amendment).

¹⁴ 80 Fed. Reg. at 41,411.

¹⁵ The Standardized Approach is the denominator calculation of the generally applicable capital standard.

¹⁶ 80 Fed. Reg. at 41,411.

¹⁷ *Id.*

The reasons for adopting the amendments in the Advanced Approaches apply with equal force in the Standardized Approach, and the 2015 amendment did not cite any substantive difference in the risk-based capital frameworks as justifying a difference in risk-weighted asset treatment. Differences in CM banks' financial intermediary regulatory capital requirements in the Advanced Approaches and the standardized approach are not justified based on any policy consideration. ABA urges the Agencies to carry over the Advanced Approaches treatment into the standardized approach to correct the disproportionately punitive treatment of financial intermediary structures.

Thank you very much for considering these issues. If the Agencies would like additional information regarding these comments, please contact Hugh Carney, at (202) 663-5324 (hcarney@aba.com).

Sincerely,

/s/

Hugh Carney
Vice President of Capital Policy