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December 21, 2017

Ann E. Misback, 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-1576
RIN 7100 AE-74

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
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RIN 3064-AE59

Legislative and Regulatory Activities Division
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Docket ID OCC-2017-0018
RIN 1557-AE10

Re: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

Ladies and Gentlemen:

Capital One[1] appreciates the opportunity to comment on the joint proposal by the Board of Governors of the Federal Reserve System ("Federal Reserve"), the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively, the "Agencies") to revise certain aspects of the Basel III regulatory capital rules (the "Proposal").[2] We welcome the

[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 $239.1 billion in deposits and $361.4 billion in total assets as of September 30, 2017. 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 branches located primarily in New York, Louisiana, Texas, Maryland, Virginia, New Jersey, 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.

[2] *Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*, 82 Fed. Reg. 49,984 (Oct. 27, 2017) (hereinafter *Simplifications NPR*). The Simplifications NPR followed the previous proposal by the Agencies to delay certain transition provisions of the Basel III regulatory capital rules for

review of the current treatment of certain deferred tax assets ("DTAs") for regulatory capital purposes and believe that the proposed revisions to the treatment of DTAs should be expanded to all banking organizations subject to the Basel III capital rules. This letter supplements the letter we submitted more generally on the Proposal together with several other regional banks.[3]

The current treatment of DTAs arising from temporary differences that an institution could not realize through net operating loss carrybacks ("temporary difference DTAs") under the Basel III capital rules is overly conservative. We believe now is an appropriate time to review the U.S. capital treatment of these assets for several reasons. First, simplifying and revising the treatment of temporary difference DTAs would be consistent with the principles underlying Executive Order 13772[4] and the recommendations made in the related report released by the United States Department of the Treasury (the "Treasury Report").[5] Second, revisions to the accounting provisions for credit losses, which will replace the incurred-loss approach for establishing loan and lease loss reserves with the current expected credit loss model ("CECL") under U.S. generally accepted accounting principles ("U.S. GAAP"), will fundamentally change the manner in which U.S. banks account for allowance for loan and lease losses, which will correspondingly drive significant increases in DTAs. Finally, reforms being considered by Congress to the U.S. tax code will, if enacted, revise significant aspects of the tax code impacting DTAs for banking organizations. The impact of the foregoing developments will have significant impact on banking organizations of all sizes and business models, and may result in unintended but sizable increases in the level of capital that banking institutions with DTAs are required to hold. Against the backdrop of these developments, we believe that it is quite appropriate to revisit the current treatment of DTAs for all institutions.

Under the Basel III capital rules, temporary difference DTAs currently are subject to a 10% common equity tier 1 ("CET1") deduction threshold and, together with certain other assets, are subject to an aggregate 15% CET1 deduction threshold. Under the Proposal, for banking organizations not subject to the advanced approaches ("non-advanced approaches institutions"), the Agencies, among other proposed revisions, would eliminate the aggregate CET1 deduction threshold and increase the individual deduction threshold for DTAs to 25% of CET1. The Agencies state that the proposed revisions are intended to reduce unnecessary burden. The Proposal further notes the Agencies' conclusion that the proposed revision to the treatment of

certain banking organizations, *see Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations That Are Not Subject to the Advanced Approaches Capital Rules*, 82 Fed. Reg. 40,495 (Aug. 25, 2017), which was finalized by the Agencies in November*, see Regulatory Capital Rules: Retention of Certain Existing Transition Provisions for Banking Organizations That Are Not Subject to the Advanced Approaches Capital Rules*, 82 Fed. Reg. 55,309 (Nov. 21, 2017).

[3] *See* letter from Capital One Financial Corporation, The PNC Financial Services Group, Inc. and U.S. Bancorp, dated December 21, 2017 ("Joint Letter").

[4] Executive Order 13772, *Core Principles for Regulating the United States Financial System*, 82 Fed. Reg. 9965 (Feb. 8, 2017) (establishing a set of core principles for regulating the U.S. financial system) (hereinafter *Executive Order*).

[5] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities - Banks and Credit Unions (June 2017), *available at* https://www.treasury.gov/press-center/press-releases/ Documents/ A%20Financial%20System.pdf (hereinafter *Treasury Report*).

DTAs is consistent with safety and soundness.[6] We fully support the Agencies' focus both on eliminating unnecessary complexity from the capital rules and on ensuring that any changes to the capital rules are consistent with safety and soundness. We strongly believe that those principals warrant extending the proposed revisions to banking organizations subject to the advanced approaches capital rules ("advanced approaches institutions").

Overly conservative treatment of temporary difference DTAs has unnecessarily procyclical impacts that threaten, rather than strengthen, safety and soundness. DTAs typically increase when a banking organization realizes significant provision expenses, which can occur during stressed conditions. Those conditions that result in significant increase in loan loss reserves also may create stress on capital levels. Due to the unduly restrictive 10% CET1 deduction threshold, downward pressure on capital at the same time that temporary difference DTAs are increasing would reduce the amount of such DTAs that can be included in capital. This procyclicality arises not only in an actual downturn, but as a practical matter impacts capital levels at institutions during normal economic times through the stress testing and capital planning processes. The implementation of CECL will further exacerbate this concern as CECL is broadly expected to increase the levels of loan and lease loss reserves, and therefore DTAs, at banking institutions.[7]

The Proposal would increase the current CET1 threshold deduction for some institutions, which would alleviate the unnecessary risk that those institutions in stress would have to deduct excess temporary difference DTAs resulting in increased capital impacts at the exact time when capital is the most expensive. The Agencies' proposal to increase this threshold reduces this unnecessary risk of procyclicality, for that subset of institutions. We believe, as the Proposal states, that the increase in the CET1 threshold deduction for temporary difference DTAs would be consistent with safety and soundness. The Agencies state that a revised 25% CET1 threshold deduction would continue to ensure that banking organizations do not have unsafe or unsound concentrations of temporary difference DTAs. We agree. The Agencies do not, however, provide any basis for determining that it is consistent with safety and soundness for one institution to be subject to a 10% CET1 threshold deduction for temporary difference DTAs while another is subject to a 25% CET1 threshold deduction for such DTAs. Nor do the Agencies assert that advanced approaches institutions are less likely to be able to realize value from temporary difference DTAs.

As discussed in more detail in the Joint Letter, the distinction between advanced approaches institutions and non-advanced approaches institutions, although often referred to as a distinction based on complexity or risk, is based solely on whether an institution has $250 billion or more in total assets, or $10 billion or more in total on-balance sheet foreign exposure. Neither line is an adequate proxy to distinguish between institutions above or below that line based on risk profile, business model, or complexity. We do not believe any compelling policy rationale exists to draw a line based on size to determine whether certain institutions should be required to hold greater amounts of capital against temporary difference DTAs than others. Increasing the threshold

[6] Simplification NPR at 49,986.

[7] Separately, we believe that adjustments are warranted to the Basel III capital rules to ensure appropriate calibration between the regulatory capital and accounting frameworks for accounting provisions as a result of CECL. We urge the Agencies to seek public comment on what changes would be appropriate.

deduction for such DTAs for only a subset of institutions should not result in an uneven playing field amongst institutions solely based on an arbitrary size-based threshold.

With respect to tax reform, a number of legislative changes contemplated to the U.S. tax code likely will have negative impacts to regulatory capital as a result of impacts to DTAs, which warrant extending the Agencies' proposed revisions to regulatory capital treatment of DTAs to all banking institutions. First, a reduction in the corporate tax rate will result in a corresponding reduction in the value of DTAs for any given amount of temporary differences. In the quarter of enactment, banks with DTAs will experience an immediate reduction to capital when existing DTAs are remeasured using the lower corporate tax rate. Second, current tax law allows tax net operating losses ("NOLs") to be carried back two years against previous taxes paid. In terms of actual results, Capital One and many other institutions have not incurred actual NOLs, even during the recent financial crisis, and have been able to realize the benefit of reversing DTAs against taxable income as earned and reported. However, the two year NOL carryback has been important under the Basel III capital rules because temporary difference DTAs that could be carried back as NOLs if they reversed on a given balance sheet date are fully allowable in CET1 without regard of the 10% CET1 threshold. If the NOL carryback is eliminated, as contemplated in proposed tax legislation, banks with DTAs will experience a significant reduction in their capacity to include temporary difference DTAs in CET1 absent an increase in the current 10% CET1 threshold for temporary difference DTAs that exceed available NOL carrybacks. The impact of this change will be even greater when evaluated in the context of company-run and supervisory stress tests. These tax reform provisions are not intended to increase capital requirements, even though they likely will have exactly that impact under the current CET1 deduction threshold levels. Moreover, given that the stated goal of anticipated tax reform legislation is to encourage economic growth, if the Agencies do not act to extend the proposed revisions to all institutions, the de facto increase to capital requirements on advanced approaches institutions will constrain the ability of such institutions to extend credit and support that growth. Extending the proposed revision to the threshold deduction to all institutions will significantly alleviate these risks, consistent with safety and soundness.

We recognize the Agencies historically have been concerned with the ability of banking organizations to realize temporary difference DTAs against future taxable income, in particular the concern that an organization may not be able to realize value under adverse financial conditions. The capital rules are premised upon banking organizations as going concerns, not failed entities, and therefore the concern that future taxable income will not exist against which DTAs could be used or realized should not be a driving consideration. Moreover, over twenty years have passed since changes to U.S. GAAP treatment of DTAs first permitted to inclusion of DTAs dependent on future taxable income. Experience has shown that valuation allowances have been established with appropriate conservatism such that temporary difference DTAs are valuable assets the inclusion of which in capital should not be overly constrained. A key consideration when evaluating the ability of a banking organization to realize DTAs is the time period over which such assets could be realized. Unless an institution is liquidated, which is seldom the case for banking organizations, DTAs are likely to be realized at some future point in time, particularly given that they already are carried on an institution's balance sheet net of related valuation allowances, and therefore include only amounts more likely than not to be realized. This conclusion is supported by the structure and design of the Federal Reserve's

Comprehensive Capital Analysis and Review ("CCAR") exercise. CCAR is specifically designed to ensure that banks have sufficient capital to be going concerns even after experiencing severe stress—i.e., that institutions, even after severe stress, will have future taxable income against which such DTAs will be used or realized. It is unwarranted to retain the existing overly conservative treatment for temporary difference DTAs, and the Agencies proposal to increase the threshold deduction for such assets to 25% is consistent with the understanding that institutions should be able to realize the value of such assets.

The distinction between permitting non-advanced approaches institutions to include increased amounts of these assets in capital, but not advanced approaches institutions, is not supportable by any evidence that temporary difference DTAs at advanced approaches institutions are less likely to be realized than those at non-advanced approaches institutions. The only reason to limit this aspect of the Proposal to non-advanced approaches institutions is to impose more stringent capital requirements on advanced approaches institutions through the Proposal. Such a policy decision is unwarranted and not consistent with the Treasury Report or the Executive Order as it would unnecessarily reduce the ability of institutions subject to the more stringent treatment from being able to extend credit as compared to institutions to which the revised treatment is provided. Advanced approaches institutions presently are subject to a number of provisions in the Basel III capital rules intended to impose more stringent capital requirements on such institutions, including the countercyclical capital buffer and the supplementary leverage ratio. The capital treatment of DTAs, and its revision for only a subset of institutions, should not be a vehicle for imposing more stringent capital requirements on one set of institutions given that there is no policy reason to distinguish between DTAs held among these different classes of institutions.

For the foregoing reasons, we urge the Agencies to revisit the treatment of DTAs not only for non-advanced approaches institutions but for all institutions.

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We thank the Agencies for the opportunity to comment on the Proposal and respectfully ask for consideration of the recommendations and suggestions in this letter and the Joint Letter. If you have any questions regarding the content of this letter or would like more information on the same, please do not hesitate to contact the undersigned at scott.blackley@capitalone.com.

Sincerely,

[redacted]

R. Scott Blackley
Chief Financial Officer