December 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

The Honorable Joseph Otting
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, S.W.
Washington, D.C. 20219

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

Dear Chairman Gruenberg, Chair Yellen, and Comptroller Otting:

The American Bankers Association[1] (ABA) appreciates the opportunity to comment on the Agencies' proposal entitled "Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996" (Simplification Proposal).

ABA supports efforts to simplify and improve the current regulatory capital framework, and we appreciate this important step by the Agencies in this important process, positive both for better supervision and improved bank management. Over the last two decades, the regulatory capital framework has grown more complex than it needs to be for the financial stability or supervisory value it provides. ABA applauds the Agencies' efforts to simplify the generally applicable risk-based capital standards to address unnecessary complexity and provisions that needlessly inhibit economic growth or constrain banks in fulfilling their core functions. We view the

[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.

Simplification Proposal as an important first step to achieving a simpler and improved regulatory capital framework. We encourage the Agencies not only to continue these efforts when reviewing the generally applicable capital standards, but also to consider whether the advanced approaches and leverage ratio frameworks can be improved as recommended in ABA's Capital White Paper, submitted to the Secretary of the Treasury in April 2017.[2]

ABA further appreciates the Agencies' dedication to informing the industry and public about the Simplification Proposal. The Community Bank Summary,[3] Capital Simplification NPR Estimator Tool,[4] and interactive teleconference hosted by the Agencies[5] have helped facilitate informed comment. These steps, along with the EGRPRA outreach meetings, have made the regulatory capital simplification effort transparent and more likely to yield optimal results.

We offer our recommendations about how the Simplification Proposal and the generally applicable capital standards can be improved in the following three sections below.

- Section 1 reaffirms ABA support for increasing the regulatory deduction thresholds.
- Section 2 offers improvements to the High Volatility Acquisition Development and Construction (HVADC) definition.
- Section 3 responds to question 14 of the Simplification Proposal.

This letter includes an Appendix outlining additional improvements to the generally applicable capital standards the Agencies should seek to implement.

ABA recognizes that improving regulatory capital requirements will be an iterative process. Consequently, and because the current regulatory deductions are unnecessarily punitive, ABA recommends that the Agencies split the Simplification Proposal into two rulemakings to permit the regulatory deductions portion of the proposal to be finalized as described in Section 1 as soon as possible.

I. Regulatory Deductions for MSAs, Holdings of Regulatory Capital Instruments Issued by Financial Institutions, and Certain DTAs

The threshold deduction provisions are among the more complex aspect of the Basel III final rule. Generally, the provisions include an individual deduction threshold set at 10% of common equity tier 1 (CET1) as well as an "aggregate deduction threshold" 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 supports the Simplification Proposal's elimination of the 15% deduction limit.

[2] White Paper available at: https://www.aba.com/Advocacy/Issues/Documents/ABA-White-Paper-Regulatory-Capital-Standards.pdf.

[3] https://www.fdic.gov/regulations/capital/capital/community-bank-summary-20170927.pdf.

[4] Located at: https://www.fdic.gov/regulations/capital/capital/index.html.

[5] Also available at: https://www.fdic.gov/regulations/capital/capital/index.html.

a. Raise the MSA Deduction Threshold to at Least Twenty Five Percent and Retain the 100 Percent Risk Weight

Servicing mortgage loans is a specialty of many banks and has long provided a strong source of stable 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 non-bank mortgage servicers at an alarming rate, a shift in market share that we do not believe was intended by the Agencies nor beneficial to mortgage borrowers. 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 been pleasant 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.

Since 2015 ABA has recommended (in various comment letters and white papers) raising the MSA deduction threshold from 10% to at least 25% of CET1. A 25% deduction threshold, 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. As a result, ABA supports the Simplification Proposal's revisions to the MSA deduction threshold. Experience may recommend to the Agencies further upward adjustments in the future.

We believe it is also important for the Agencies to reconsider the treatment of the portion of MSAs that are not deducted. Increasing the risk weighting on MSAs to 250% would dramatically increase the amount of capital that must be held for this asset. MSAs are already subject to yearly valuation analyses under current accounting rules, which ensures that they are carried at or below market value. In addition, banks have a long track record of successfully hedging the interest rate risk associated with MSAs. This is completely ignored in the risk-based capital treatment. No other asset class is penalized in this manner, and such treatment is unwarranted. We believe the risk weight should be set at no higher than 100%.

b. Refine the Treatment of 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*

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. Consistent with past ABA requests, the Simplification Proposal eliminates this distinction and establishes a

combined limit on these investments of 25% of CET1. While ABA is supportive of this aspect of the proposed rule, we also urge the Agencies to 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) securities and unsecured long-term debt).[6]

ii. *Grandfather the capital treatment of TruPS investments*

As outlined in ABA's Capital White Paper (submitted to the Secretary of the Treasury in April 2017), existing Trust Preferred Securities (TruPS) held by banks as investments should not be subject to the Basel III capital deduction. TruPS provided a means for smaller banking organizations to access capital/debt markets by issuing securities pooled into collateralized debt obligations (CDOs). In practice, TruPS could absorb losses when an individual bank was in difficulty, but when the entire market was in decline, they proved to be vulnerable to market losses. 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 grandfathering 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 existing TruPS, 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 they fail to honor this intent in the *capital rules* for banks investing in TruPS. This unnecessarily penalizes the capital position of investing 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 current accounting rules.

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

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[6] 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.

d. Raising the Deduction Threshold for DTA's Resulting from Timing Differences and Retaining their 100 Percent Risk Weight

ABA supports the Simplification Proposal's increase in the deduction threshold for DTAs. 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 CECL 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. The increase in the deduction threshold should allow for a smoother transition to the CECL standard. In addition we believe it is also important for the banking Agencies to reconsider the treatment of DTAs resulting from timing differences that are not deducted. We believe that the risk weight should be set no higher than 100%.

We urge the Agencies to continue to monitor the Administration's attempts to revise the tax code. These efforts could result in unintended consequences such as the elimination of some DTAs. Should the Agencies deem appropriate, they should be prepared to phase in for regulatory capital purposes any unintended impacts of new tax laws.

e. Scope of Deduction Relief

The Simplification Proposal's amendments to the deduction thresholds (MSAs, Timing Difference DTAs, etc.) are unnecessarily limited to non-advanced approaches banking organizations. 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 Simplification Proposal, however, by drawing these unjustifiable lines would add unnecessary complexity to the overall framework while preserving capital treatment that the Agencies have already determined to be unjustified. Comparing institutions, particularly those near the $250 billion threshold used to designate advanced approaches banks, could become even more complex and confusing.

As a result, ABA urges the Agencies to extend the amendments to the deduction thresholds to all banks when calculating the risk based capital ratios under the standardized approach. Having a consistent capital definition under the standardized approach would facilitate appropriate peer comparisons across the industry. In addition, we encourage the Agencies to urge the Basel Committee to revisit these treatments internationally.

II. High Volatility Acquisition, Development, or Construction Exposures

a. Overview of HVADC Recommendations

The Simplification Proposal would replace the existing high volatility commercial real estate (HVCRE) exposure category with a newly defined exposure category called high volatility acquisition, development, or construction (HVADC).[7] The new HVADC category would apply in the standardized approach for all banks.

While the Agencies state that they intend for the HVADC exposure definition to reduce regulatory burden meaningfully and be substantially simpler to implement, the proposal, as written, rather would increase regulatory capital costs. It would also likely prove to be a drag on economic growth. Both would result because the proposal increases the scope of loans subject to a 130% risk weight, including loans not secured by real estate. Indeed, even many acquisition, development, and construction (ADC) loans with substantial borrower equity that would have been exempt under HVCRE—and therefore be subject to a 100% risk weight—would be considered HVADC and be subject to a 130% risk weight. Banks would originate comparatively fewer ADC loans if the HVADC exposure definition, as proposed, were adopted. In addition, the cost of holding more capital on ADC financing would result in higher credit costs. We do, however, generally support the proposed grandfathering provision, which would retain the capital rule's treatment for ADC exposures outstanding or committed as of the effective date of any rule.[8] This treatment is reasonable, and it would even mitigate some of the burden of having to reevaluate all ADC exposures against the new definition—which, however, we recommend be amended, as discussed below.

The Agencies state that supervisory experience has demonstrated that ADC exposures present heightened risk compared to other commercial real estate exposures. We understand that the Agencies believe a lower risk weight of 130% for HVADC is appropriate given the expanded scope of HVADC relative to HVCRE, which applied a 150% risk weight to a smaller subset of ADC loans. However, the Agencies provide no argument for the efficacy of a 130% risk weight relative to the likely constraining effect that this proposal will have on ADC lending and economic growth more broadly. ADC loans are far from homogeneous, and their risk characteristics vary across a number of potential metrics, including but not limited to loan-to-value and debt service coverage ratios. The Agencies should consider whether they can better accomplish their objectives through supervisory means, that would recognize and address variations among ADC loans, rather than applying a blanket risk weight—which is likely to be more often misapplied than accurate with respect to actual risk—on most commercial-purpose ADC loans.

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[7] 82 Fed. Reg. 49986.
[8] 82 Fed. Reg. 49988.

While definitional simplicity is certainly a worthy goal, we believe that the Agencies can strike a better balance between risk-sensitivity and procrustean simplicity. ABA offers the following recommendations to strike that balance:

- Exclude ADC loans not secured by real estate from the definition of HVADC.
- Maintain the 15% contributed capital exemption criterion in the proposed HVADC definition, subject to some modifications.
- Specify that the "primarily finances or refinances test" be assessed at loan inception.
- Exempt bridge loans not satisfying the "primarily finances or refinances test" from the definition of HVADC, and remove the statement that a permanent loan does not include "a loan that finances or refinances a stabilization period".
- Apply the same HVADC definition in the standardized approach, subject to the revisions we propose, to the advanced approaches.

b. ADC Loans Not Secured by Real Property Should Not Be Considered HVADC

The Simplification Proposal states that "an acquisition, development, or construction exposure that is not secured by real property could be considered an HVADC exposure…"[9] This is not consistent with the long-standing ADC loan definition, characterization, and guidance under Bank Call Reporting Instructions, which exclude such loans.[10] Excluding exposures that are not secured by real property would avoid capturing unsecured loans to creditworthy real estate entities for general corporate purposes where loan repayment is not dependent on a single asset. Such loans are subject to different underwriting standards given their unique risk characteristics. Subjecting them to HVADC is a misapplication. ABA recommends the Agencies exclude ADC loans not secured by real property from the scope of HVADC.

c. Support Maintaining 15 Percent Contributed Capital Exemption Criterion in Proposed HVADC Definition, Subject to Some Modifications

The Simplification Proposal does not include for HVADC exposures the 15% capital contribution exemption that is available for HVCRE exposures.[11] ABA believes that the exemption better reflects exposure risk and so should be available for HVADC exposures, slightly modified. The objective of risk-based capital rules is to be risk-sensitive, and one of the key differentiators in HVADC risk is how much capital the borrower contributes. Borrower-contributed capital serves as a cushion and protection from the possible erosion in economic value of the project under consideration, without which bank balance sheets will be more exposed to cyclical volatility. Loans containing 15% contributed capital also have a stronger commitment from the borrower regarding the successful completion of the project. Furthermore,

[9] 82 Fed. Reg 49988.
[10] *See* RC-C-2a through RC-C-6a of the FFIEC 031 and 041 Call Report Instructions.
[11] 82 Fed. Reg. 49987.

many borrowers have adjusted to the expectation that 15% capital be contributed to ADC projects in connection with the adoption of the 2013 HVCRE rules. Removing this important criterion from capital rules pertaining to ADC lending would unwisely signal to borrowers that contributing "skin in the game" is no longer an important risk mitigant.

We believe that the HVADC definition should incorporate a few modifications to the 15% contributed capital exemption contained in the HVCRE definition. These would serve to clarify many of the confusing aspects of the exemption without sacrificing risk-sensitivity.

First, ABA recommends that the "cost" value be used instead of the "as completed" value for the purposes of determining whether the loan is exempt from the HVADC exposure definition. "Cost" is a more definitive number that is more easily managed and measured throughout the development and construction of a project, whereas "as completed" is subject to many factors that are frequently more fluid and less reliable.

Second, ABA recommends that the Agencies clarify that the appreciated value of land, as determined by an appraisal, should count toward the 15 percent contributed capital amount, subject to a seasoning provision of five years. The HVCRE definition permitted the consideration of cash used to purchase land—based on the original purchase amount—toward the 15 percent contributed capital amount for the purposes of determining if an ADC loan was exempt from HVCRE. Frequently, parcels of land are purchased and combined at different times, and it can take many years to complete the development. Concurrently, planning, re-zoning, and developing off-site infrastructure can add substantial value to parcels of land that should be recognized as value and contributed capital. We recommend that the appreciated value of land be considered contributed capital, but such land should be subject to a seasoning provision of five years to counterbalance the risk that land has artificially appreciated due to speculation in a relatively compressed period of time. Differing regions of the country may experience non-speculative appreciation in land value during periods shorter than five years, but the seasoning period recommendation represents an election to create a standard that recognizes longer-term value appreciation while maintaining discipline in the marketplace.

ABA also recommends that mandatory restrictions on the withdrawal of contributed capital in excess of the 15% minimum—that were present in the HVCRE definition—not apply in the HVADC definition since such restrictions create disincentives for borrowers to contribute capital in excess of the 15% minimum.

d. The "Primarily Finances or Refinances Test" Should Be Assessed at Loan Inception

The Simplification Proposal states that an exposure would only be classified as an HVADC exposure if more than 50 percent of the loan proceeds will be used for ADC activities.[12] This

[12] 82 Fed. Reg. 49988.

new "primarily finances or refinances test" creates a new reporting obligation that is not currently present in existing regulatory reporting requirements, such as the Call Report. It is important, then, that the definitional aspects of the calculation are as clear and practical as possible with respect to certain kinds of funding obligations that may be drawn upon over time. For these kinds of obligations, ABA asks that the Agencies clarify that the "primarily finances or refinances test" be measured at loan inception, and that lenders may rely upon such a determination during the life of the loan.

e. Bridge Loans Not Satisfying the "Primarily Finances or Refinances Test" Should Not Be Considered HVADC; Remove the Statement that a Permanent Loan Does Not Include "a Loan That Finances or Refinances a Stabilization Period"

The proposed HVADC exposure definition includes a definition of "permanent loan" to delineate more clearly when an exposure ceases to be an HVADC exposure.[13] ABA believes the HVADC definition of permanent loans provides greater clarity than does the HVCRE definition. However, the Simplification Proposal's statement that bridge loans not otherwise exempt from HVADC definitions would generally be subject to a higher risk weight[14] represents a significant expansion of scope to include loans that are not typically considered acquisition, development, and construction loans. ABA recommends that the scope of the HVADC exposure definition be limited to the enumerated purposes contained in section 2 of the proposal and that bridge loans not satisfying these enumerated purposes not be included as HVADC.[15] Limiting the definition of HVADC to the enumerated purposes contained in the "primarily finances or refinances test" definition would have the added benefit of ensuring that treatment of ADC loans for the purposes of this proposed rulemaking would be consistent with the way ADC loans are currently required to be reported for the Call Report. Inconsistency between the Call Report and HVADC definitions would lead to unnecessary confusion and inconsistency.

The condition of bridge loans to support activities that do not meet the "primarily finances or refinance test" definition may arise because of temporary losses in tenants, among other potential reasons. In conversation, the Agencies offered clarification that bridge loans extended against existing properties, such as shopping malls for which there has been a temporary loss in tenant(s), would be considered HVADC even though such loans do not satisfy the purpose-based definition of an HVADC exposure, per the "primarily finances or refinances test". Expanding the scope of HVADC to such bridge loans when they do not meet the definition of the "primarily finances or refinances test" would introduce significant definitional ambiguity regarding whether a loan meets the definition of HVADC. Such ambiguity would be inconsistent with the stated

[13] 82 Fed. Reg. 49987.

[14] 82 Fed. Reg. 49990.

[15] Per 82 Fed. Reg. 49988, an HVADC exposure is "a credit facility that *primarily* finances or refinances: (i) The acquisition of vacant or developed land; (ii) the development of land to prepare to erect new structures, including, but not limited to, the laying of sewers or water pipes and demolishing existing structures; or (iii) the construction of buildings or dwellings, or other improvements including additions or alterations to existing structures."

intention of the Agencies that HVADC be simpler to implement than HVCRE. We note also that such an expansion in scope may result in inconsistency in the regulatory capital treatment of bridge financing facilities.

Loans for which there has been a temporary loss of tenant(s), as part of the annual review process, may be identified for modifications or, in some cases, impairment or downgrades, potentially resulting in additional provisioning expenses to increase the allowance for loan and lease losses. Under the Simplification Proposal, banks incurring additional provisioning expenses would concurrently need to increase risk-based capital allocations by 30% as a result of the loan being considered a bridge loan and therefore subject to HVADC, for reasons outside of the bank's control. The resultant increase in both provision expenses and risk-based capital requirements would be a significant deterrent to working with borrowers in times of stress. ABA believes that the "double hit" that banks will incur is unnecessarily punitive.

The HVADC exposure definition also provides that a permanent loan does not include a loan that finances or refinances a stabilization period.[16] This statement has caused considerable confusion and uncertainty, and we ask that it be removed. The term "stabilization period" is imprecise, subjective, and vulnerable to a wide range of interpretations, depending on numerous factors. Consistent application would be unattainable. This language is unnecessary, as the definition of permanent loan is clear on its own.

f. Apply the Same HVADC Definition in the Standardized Approach, Subject to the Revisions We Propose, to the Advanced Approaches

Under the Simplification Proposal, advanced approaches banking organizations would use the HVADC definition when calculating their standardized approach risk based capital ratios and the HVCRE definition when calculating their advanced approaches risk based capital ratios.[17] There is no risk-based justification for such differential treatment. Moreover, because of the significant differences between the HVADC and HVCRE definitions, it would be unnecessarily burdensome for advanced approaches banking organizations to track two separate definitions. ABA urges the Agencies to apply the same HVADC definition for all banks (with the modifications we recommend).

Failure to harmonize the HVADC and HVCRE definitions could negatively affect loan liquidity in syndication markets. Advanced approaches banking organizations would be reluctant to participate in new ADC loans originated by *non*-advanced approaches banks if such loans do not comport with HVCRE definitions, particularly regarding contributed capital exemption criterion that may vary under HVADC and HVCRE definitions.

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[16] 82 Fed. Reg. 50016.
[17] 82 Fed. Reg. 49991.

For advanced approaches banking organizations, the grandfathering provision applicable to existing HVCRE exposures made prior to the effective date of any final rule should be optional, as divergent assessment methodologies under the standardized approach and advanced approaches would lead to overcomplicated operational procedures. Thus, we ask that advanced approaches firms have the option to apply the HVADC definition, with the changes proposed in this comment letter, without regard to the origination date of the loan.

III. Response to Question 14: ABA Supports the Concept of a Highly Capitalized Bank Exception to the Risk Based Capital Standards

The banking industry is firmly committed to effective capital standards that require banks to have adequate levels of high quality capital. We understand this to be the purpose of the Basel III capital standards and the implementing regulations. We embrace that purpose. The soul of simplification is a focus on that core purpose, including the avoidance of unnecessary provisions that can distract from or even inhibit achievement of adequate levels of high quality capital and the employment of that capital to achieve the economic roles of banks for the economy and for bank customers.

For many banks that does not require an implementation regime of hundreds of pages of rules to convert that purpose into reality. Many banks today maintain capital levels far in excess of any amounts that would be required even after a fulsome application of the complex evaluations, measurements, and calculations mandated under the Basel III regulations. For those banks, this considerable and costly work would yield no additional supervisory or safety and soundness benefits. Neither would it provide any service of any kind to any potential bank customer.

We encourage the Agencies to explore simple ways of identifying highly capitalized banks and provide the option to those identified banks to be excluded from the risk based capital regime. We note that the Senate is currently considering an approach that would identify highly capitalized banks by using a simple capital-to-assets ratio that is no lower than 8% and no higher than 10% and exempting these banks from the risk based capital standards. ABA has long been supportive of this approach, and thus we support this bipartisan effort. We do not believe that the Agencies need wait for legislation, however, to implement this simplifying concept.

This concept is not intended to *reduce* the amount of regulatory capital banks need. It is designed instead to recognize what these banks have already achieved, a regulatory relief measure that acknowledges that these banks have significantly more regulatory capital than the Basel III standards require, which renders the complicated Basel III calculations for them superfluous, indeed a waste of bank and supervisory resources. We believe that this proposal would reduce regulatory burden for these banks by reducing staff time, outside audit costs, and even examination time at these highly capitalized banks. Nor does this proposal require a rewriting of the Basel III regulations; it merely identifies those banks for which the complex asset measurements of those requirements can be safely judged as satisfied.

ABA appreciates the opportunity to comment on this proposal. We view these efforts as an important first step to achieving a simpler and improved regulatory capital framework. We encourage the agencies to take additional steps to simplify and improve the overall regulatory capital framework (including advanced approaches and leverage ratios) as recommended in ABA's April 2017 Capital White Paper. If you have any questions about the content of this letter please contact Hugh Carney at (202) 663-5324 or Barry Mills at (202) 663-5311.

Sincerely,

Hugh C. Carney
Vice President of Capital Policy

Barry Mills
Senior Regulatory Advisor

Appendix -Other Recommended Amendments to the Generally Applicable Standards

In addition to comments on the Simplification Proposal, we offer some additional recommendations that will further the goal of improving the value of capital regulations for supervision and bank management purposes.

a. Unrealized Gains and Losses

In the United States, only banks subject to the advanced approaches risk-based capital standards are required to "flow through" to CET1 all unrealized gains and losses (also categorized as accumulated other comprehensive income—AOCI) from a banking organization's available for sale (AFS) portfolio. ABA opposes different definitions of capital based on bank asset size. We understand that policymakers from time to time rely upon these artificial limits for various reasons, but these fabricated asset-size divisions rarely if ever solve the problem of the non-existent real-world differences between banks just below and just above the virtual reality lines. With regard to the AOCI treatment, for example, 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 third quarter of 2017 that AOCI capital requirement resulted in bank capital increasing by $2.1 billion, by $8 billion in the second quarter, 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 recommend that the agencies amend the Basel III capital regulations so that unrealized gains and losses are not included in any banking organization's capital calculation, not dependent upon the size of the institution.

b. 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 recommends 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 Corporations.

c. 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.

The revised methodology for SFTs finalized by the Basel Committee goes a long way towards addressing these concerns. This methodology includes changes that permit the netting of loans

and offsetting collateral by counterparty in appropriate circumstances, 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 Collateral Haircuts Approach and therefore warrant inclusion as an option under the generally applicable capital rules.

ABA recommends that the Agencies propose the revised methodology for SFTs recently adopted by the Basel Committee as an option under the generally applicable capital rules for all banks.

d. 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 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 broadly similar to those for banking organizations, these exposures should be less risky than exposures to general corporates.

The Basel Committee's revised standardized approach 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…"[18] We recommend that the Agencies 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.

e. Simple Approach for Risk Mitigants

The simple approach method for recognition of the risk-mitigating effects of financial collateral under the standardized approach allows banks to apply risk-weight substitution to the portion of exposure that is secured by the fair value of any financial collateral. To qualify for the simple approach, the collateral must be subject to "a collateral agreement for at least the life of the exposure." The collateral agreement definition in section 2 of the U.S. Basel III rules provides that a contract would not meet this qualification if "the bank's exercise of rights under the agreement may be stayed or avoided under applicable law."

The reference to the risk of stays was originally incorporated in Basel II solely in relation to qualifying financial contracts (QFC), i.e. derivative contracts, eligible margin loans, and repo-style transactions under the internal models methodology, as these exposures are exempt from stay under the U.S. bankruptcy code and can therefore benefit from methodologies allowing for a direct offset of exposures. The simple approach, however, is not restricted to QFCs and should be applicable to exposures generally. Yet, exposures such as loans and letters of credit are not

[18] Page 12 of https://www.bis.org/bcbs/publ/d424.pdf.

exempted from automatic stay under the U.S. bankruptcy code. Therefore, the collateral agreement definition appears inadvertently to disallow the recognition of financial collateral for exposures other than QFCs. So that the simple approach applies consistently, we recommend that the Agencies remove the reference to a collateral agreement and instead condition the use of the simple approach with the statement, "the collateral must be pledged for at least the life of the exposure."

f. Revising the Applicability of the Eligible Guarantor Requirement in the Standardized Approach

The U.S. standardized approach allows banks to recognize the credit risk mitigation benefits of an eligible guarantee or eligible credit derivative by substituting the risk weight of the exposure with that associated with the protection provider. Part of the definition of an eligible guarantee or credit derivative is that its performance has to be backed by an eligible guarantor. This requirement of an eligible guarantor was initially introduced under the Basel III final rule across the standardized and advanced approaches but later in a clarification removed from the advanced approaches. The Agencies decided to retain the requirement for the standardized approach, given that in most cases the guarantor and the exposure would be assigned the same risk weight. While this might generally be the case, it nevertheless results in certain scenarios in suboptimal capital outcomes. This is particularly the case where the guarantor prefunds in cash the guarantee or credit derivative to the bank. For the prefunded portion, the performance of the guarantor is irrelevant. Therefore, we believe that in instances where a guarantee of credit derivative is prefunded in cash the bank should be allowed to substitute the risk weight of the exposure with that of cash even if the guarantor is not eligible or not applicable, as in the case of a credit linked note.

g. Improving the Treatment of Derivatives

i. 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.[19] 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

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

reimburse the clearing member client in the event of the CCP default."[20] 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."[21] Within the 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).[22] 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."[23] The Agencies concluded by noting that they "will consider the suggested change in the context of future proposed rulemakings."[24] We believe that the time has come to consider this change.

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 recommends that the Agencies carry over the advanced approaches treatment into the standardized approach to correct the disproportionately punitive treatment of financial intermediary structures.

ii. *Recognition of CVA losses under the CEM*

The Basel 3 advanced approaches allows banks to reduce their counterparty credit risk derivative exposures by the Credit Value Adjustment (CVA) losses that banks have already recognized in order to avoid double counting of these losses. In the 2015 revisions to the advanced approaches framework, the Agencies clarified that the same provision is not allowed for the Current Exposure Method (CEM) under the standardized approach, thereby resulting in a double count of CVA losses as well as creating a divergence from the advanced approaches. However, the Agencies noted that "the agencies are not adopting the change requested by the commenter, but will consider the suggested change in the context of future proposed rulemakings." We believe that the time has certainly arrived to make that adjustment, and we therefore request that the Agencies consider this change as a means of simplifying the capital framework by applying a consistent methodology between advanced approaches and the standardized approach.

[20] 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).
[21] 80 Fed. Reg. at 41,411.
[22] The standardized approach is the denominator calculation of the generally applicable capital standard.
[23] 80 Fed. Reg. at 41,411.
[24] *Id.*

iii. *Use of deltas to measure counterparty credit exposure under CEM for cleared and client cleared derivatives*

The CEM under the standardized approach is a risk-insensitive notional-based calculation, which overstates derivative exposures, as it does not take the riskiness of a derivative into consideration, particularly for options. CEM therefore results in banks holding excessive capital for derivatives, making it very costly to act as market makers. The standardized approach of Counterparty Credit Risk (SA-CCR) finalized by the Basel Committee in 2014 to replace CEM incorporates multiple risk-sensitive measures, including the application of delta.

Delta is based on the relationship between movements in the prices of a derivative and of its underlying assets and is widely used as a measure of trading book exposures and hedge effectiveness. Each instrument's delta is a function of a variety of risk factors at a point in time, including maturity. Thus, deltas yield a more risk-sensitive measure of exposure. Given the uncertain timeline of the adoption of SA-CCR in the U.S., we believe that CEM should be amended to allow banks to use delta adjusted notional value for calculating derivative exposures that are more consistent with the riskiness of the derivative positions. We note that the Treasury's report on Capital Markets[25] recommends that delta adjusted notional value be used to measure cleared and client cleared derivative exposures. Furthermore, the c-factor calculation for default fund contributions already allows the use of deltas in the CEM calculation.

[25] Report located at: https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf.