December 21, 2017

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Docket No. R-1576
RIN 7100 AE-74

Robert E. Feldman, Executive Secretary
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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:

We appreciate the opportunity to comment on the proposed rules issued jointly by the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), and the Office of the Comptroller of the Currency (collectively, the "Agencies") that would revise certain aspects of the Basel III regulatory capital rules (the "Simplification NPR" or "Proposal").[1] As discussed further below, we urge the Agencies to (i) expand the scope of the proposed simplifications and improvements to the U.S. regulatory capital framework to all banking organizations; (ii) eliminate the use of arbitrary and rudimentary asset thresholds as a proxy for a banking organization's risk profile; and (iii) address concerns presented by the proposed introduction of a new definition and risk-weight for certain acquisition, development, or construction ("ADC") exposures.

[1] *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 *Simplification NPR*). The Simplification NPR followed a proposal by the Agencies to delay certain transition provisions of the Basel III regulatory capital rules for certain banking organizations, which the Agencies finalized without material changes in November 2017. *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) (hereinafter *Transitions Rule*).

The Proposal would revise the regulatory capital treatment for mortgage servicing assets ("MSAs"), certain deferred tax assets ("DTAs") arising from temporary differences ("temporary difference DTAs"), investments in the capital of unconsolidated financial institutions, and capital issued by a consolidated subsidiary of a banking organization and held by third parties ("minority interests"). The changes, however, as proposed would apply only to banking organizations that have less than $250 billion in total assets and less than $10 billion in foreign exposure ("non-advanced approaches institutions"). Separately, the Proposal would revise the treatment of certain ADC exposures under the standardized approach for risk-weighting assets (subject to grandfathering of existing exposures that are outstanding or committed prior to any final rule's effective date). This revised treatment for ADC exposures would not apply to the similar ADC rules applicable under the advanced approaches for risk-weighting assets.

We welcome and support the Agencies' efforts to revisit the regulatory capital rules in order to assess whether and how the rules could be improved to avoid unnecessary burden and complexity while maintaining safety and soundness. The Agencies' efforts in this regard are consistent with the principles underlying Executive Order 13772[2] and the recommendations made in the related report released by the United States Department of the Treasury.[3] The Proposal has certain shortcomings, however, effectively creating two standardized approaches, one for non-advanced approaches institutions and one for advanced approaches institutions, and two parallel standards for many commercial real estate exposures for advanced approaches institutions, without any countervailing benefit. It is contrary to the purpose of the Agencies' efforts and the principles underlying the Executive Order and the Treasury Report to increase the complexity of, and burden under, the regulatory capital rules for institutions, agency staff, and markets in this way. We address the two major components of the Proposal sequentially below. [4]

I. Provisions Related to MSAs, Temporary Difference DTAs, Investments in Unconsolidated Financial Institutions and Minority Interests

A. The Proposed Revisions Should be Extended to All Banking Organizations

The Proposal explains that the reason behind the revisions is to "meaningfully reduce regulatory burden, especially on community banking organizations, while at the same time maintaining safety and soundness and the quality and quantity of regulatory capital in the banking system."[5] We support the proposed modifications to the treatment of MSAs, temporary difference DTAs, investments in unconsolidated financial institutions and minority interests, but we firmly believe

[2] 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*).

[3] 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*).

[4] Our organizations participated in the development of comment letters by The Clearing House Association L.L.C. and the American Bankers Association. We generally support the comments and concerns reflected in those letters, and the recommendations in this letter are intended to highlight those aspects of the Proposal that present special concerns for the undersigned regional banking organizations.

[5] Simplification NPR at 49,986.

that the Proposal should be revised so that the proposed simplifications are extended to all banking organizations.

From the Proposal, it is clear that the Agencies have determined that the proposed modifications relating to MSAs, temporary difference DTAs, investments in unconsolidated financial institutions and minority interest can be made *without threatening the safety and soundness of banking organizations*. For example, the Agencies state the following:

- The "imposition of [a single] 25 percent common equity tier 1 capital deduction threshold [for MSAs, temporary difference DTAs and investments in unconsolidated financial institutions] is expected to avoid, in a simple manner, unsafe and unsound concentration levels of MSAs, temporary difference DTAs and investments in the capital of unconsolidated financial institutions."[6]

- "The agencies believe the proposed treatment for investments in the capital of unconsolidated financial institutions would reduce complexity while maintaining appropriate incentives to reduce interconnectedness among banking organizations."[7]

- "The agencies believe that removing the current complex calculation for the amount of includable minority interest reduces regulatory burden without reducing . . . safety and soundness . . . because the proposed minority interest limitations are simpler to calculate and still appropriately restrictive."[8]

These very same conclusions support the extension of these simplifications to *all* banking organizations, including advanced approaches banking organizations, and demonstrate that doing so would be fully consistent with safety and soundness. Accordingly, we urge the Agencies to extend these simplifications to all banking organizations.

B. Any Distinctions Based on an Organization's Risk Profile Should Utilize a Standard That Accurately Reflects an Organization's Risk Profile

The Agencies claim that the current provisions governing MSAs, temporary difference DTAs, and investments in unconsolidated financial institutions should be retained for advanced approaches institutions "because their size, complexity, and international exposure warrant a risk-sensitive treatment that more aggressively reduces potential interconnectedness among such firms."[9] Similarly, the Proposal claims that the existing minority interest rules should continue to apply to advanced approaches organizations due to "their size, complexity, and risk profile."[10]

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[6] Simplification NPR at 49,992.

[7] Simplification NPR at 49,993

[8] Simplification NPR at 49,994.

[9] Simplification NPR at 49,993. It is not at all clear how the current deductions for MSAs and temporary differences might reduce interconnectedness among banking organizations to any greater degree than the simplifications included in the Proposal.

[10] Simplification NPR at 49,994.

We agree that regulations should be tailored based on the complexity and risk profile of a banking organization. The problem with the Proposal, however, is that it uses the advanced approaches thresholds—which are largely based on size—as the measure of an organization's complexity and risk profile, rather than more robust factors that would adequately represent an assessment of the institution's complexity, business model, and risk profile. A banking organization is subject to the advanced approaches if it has $250 billion or more in total consolidated assets, or $10 billion or more in total on-balance sheet foreign exposure (the "AA Thresholds"). The AA Thresholds, which are unique to the United States, were first established by the Agencies in 2003 to identify those banking organizations deemed "internationally active" and to which the advanced approaches under the regulatory capital rules should apply on a mandatory basis.[11] Moreover, the AA Thresholds have never been comprehensively reviewed in the intervening 14 years to evaluate whether they then were, or today are, an appropriate proxy for the complexity and risk profile of an organization.

In fact, there is a growing consensus that asset size, in and of itself, is a poor proxy for a bank's complexity and risk profile. For example, FDIC Vice Chairman Thomas M. Hoenig has commented that "regulation should focus on the business model *rather than arbitrary asset-size thresholds*."[12] These comments echo those of other policymakers,[13] including Federal Reserve Governor Jerome Powell[14] and then-Acting Comptroller of the Currency Keith A. Noreika.[15] Moreover, the Office of Financial Research, in a recently published reported, highlighted that size alone is not adequate to distinguish the risk amongst different financial institutions.[16] That report concludes that for "large banks that are not G-SIBs, asset-size thresholds are too simplistic to assess systemic importance . . ." and that "[f]or this . . . tier of banks, a modified version of the G-SIB multifactor approach could help determine the appropriate level of enhanced regulation."[17]

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[11] *See Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord*, 68 Fed. Reg. 45,900 (Aug. 4, 2003).

[12] Thomas M. Hoenig, *BankThink A bank's activities, not its assets, should decide regulatory status*, Am. Banker (Nov. 16, 2017) *available at* https://www.americanbanker.com/opinion/a-banks-activities-not-its-assets-should-decide-regulatory-status (emphasis added). *See also* Thomas M. Hoenig, Statement on the Senate Banking Committee passage of S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act (Dec. 5, 2017) *available at* https://www.fdic.gov/news/news/speeches/spdec0517.html.

[13] Testimony of former Chairman Barney Frank in a hearing before the Committee on Financial Services, U.S. House of Representatives, *Assessing the Impact of the Dodd-Frank Act Four Years Later* (July 23, 2014) (responding to questions from members of the Committee regarding whether a banking organization's systemic importance should be based solely on size).

[14] Testimony of Gov. Jerome Powell in a hearing before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, (Nov. 28, 2017).

[15] Remarks by Keith A. Noreika, Acting Comptroller of the Currency, at the Midsize Bank Coalition of America Chief Risk Officer Meeting (Oct. 5, 2017) (highlighting that arbitrary thresholds have adverse effects).

[16] Office of Financial Research, *Size Alone is Not Sufficient to Identify Systemically Important Banks* (Oct. 26, 2017).

[17] *Id.* at 16.

It is not surprising, then, that the AA Thresholds do a poor job of identifying and distinguishing organizations with materially different (or similar) risk profiles and levels of complexity. Regional banking organizations generally have similar business models and, thus, have risk profiles that are more similar to each other than they are to the risk profiles of U.S. global systemically important banks ("G-SIBs"), even though the AA Threshold subjects a number of regional banks to many of the same requirements as G-SIBs, rather than the requirements applicable to their much more similar regional peers.

Our regional banking organizations' business models are focused on core, traditional commercial banking activities, such as deposit taking, consumer and commercial lending, and asset management. Virtually all assets of our regional banking organizations are held in our depository institution subsidiaries, which is not the case on average for G-SIBs, which have significant non-banking operations. As compared to our regional banking organizations, G-SIBs are significantly more interconnected, having broker-dealer and investment banking operations that are large on both an absolute and relative scale. G-SIBs are engaged in significant capital markets, derivatives, and trading activities, unlike our organizations, which have limited capital markets, custody, clearing, and derivative operations.

Although we do engage in limited trading and derivatives activities, those activities are focused on accommodating lending customers or on prudent hedging of our organization's risks, rather than on broad market making in financial instruments. These differences are clear in the size of trading assets and liabilities of our organizations as compared to G-SIBs. G-SIBs are truly internationally active, having significant global operations, as compared to our organizations, which have only limited foreign activities. Significantly, G-SIBs have been found by the Federal Reserve and the Financial Stability Board to be globally systemically important; we have not.

These meaningful differences in business model mean that the balance sheets and risk profiles of our regional banking organizations ("Excluded Regionals") are very different from the balance sheets and risk profiles of the eight U.S. banking organizations identified as G-SIBs. On the other hand, the balance sheets and risk profiles of our organizations are very similar to that of other regional banking organizations that are not covered by the advanced approaches ("Other Regionals") and, thus, are covered within the scope of the Proposal.[18] The following data demonstrate these points:[19]

- Excluded Regionals and Other Regionals hold 62% and 66%, respectively, of their total assets in net loans and leases, as compared to G-SIBs which hold on average only 27% of their total assets in net loans and leases.

[18] The banking organizations referenced here include the following U.S. regional bank holding companies with asset of $50 billion or more that are not covered by the advanced approaches, excluding intermediate holding companies of foreign banking organization and savings and loan holding companies: BB&T Corporation, CIT Group Inc., Citizens Financial Group, Inc., Comerica Incorporated, Fifth Third Bancorp, Huntington Bancshares Incorporated, Keycorp, M&T Bank Corporation, Regions Financial Corporation, SunTrust Banks, Inc., and Zions Bancorporation.

[19] Data is based on information reported on Form FR Y-9C and other public financial and regulatory reports, as of or for the period ending September 30, 2017.

- Excluded Regionals and Other Regionals have an average ratio of core deposits to total liabilities of 71% and 81%, respectively, as compared to G-SIBs, for which this ratio on average is only 34%.

- Excluded Regionals and Other Regionals have less than 1% of their total assets on average held in non-bank broker-dealer subsidiaries, whereas G-SIBs on average hold 24% of their total assets in non-bank broker-dealer subsidiaries.

- Excluded Regionals and Other Regionals each have an average ratio of total trading assets to total assets of only 1%, whereas G-SIBs on average have a ratio of total trading assets to total assets of 14%. Similarly, Excluded Regionals and Other Regionals each have an average ratio of total trading liabilities to total liabilities of less than 1%, whereas G-SIBs on average have a ratio of total trading liabilities to total liabilities of 6%.

- Excluded Regionals and Other Regionals have an average ratio of notional value of derivative contracts to total assets of only 79% and 48%, respectively, as compared to on average 2,116% for the G-SIBs.

- Excluded Regionals and Other Regionals have an average reliance on wholesale funding ratio of only 23% and 16%, respectively, whereas the G-SIBs have an average reliance on wholesale funding ratio of 41%.

- Excluded Regionals and Other Regionals have an average ratio of foreign loans to total loans of only 2% and less than 1%, respectively, as compared to 15% on average for the G-SIBs.

- Finally, the highest systemic indicator score for an Excluded Regional is only 45, which is less than one third of the lowest systemic risk indicator score for a G-SIB, which is 149.

The foregoing data clearly demonstrate that the AA Thresholds do not appropriately distinguish between banking organizations based on business model, complexity, or risk profile, but rather they differentiate almost entirely based on size.

For these reasons, we believe the Proposal should, at a minimum, be extended to cover our organizations. We note that applying the proposed modifications only to U.S. G-SIBs would still ensure that U.S. banking organizations that represent approximately 86% of cross-jurisdictional claims and 92% of cross-jurisdictional liabilities (both as reported on the June 30, 2017, FR Y-15 Banking Organization Systemic Risk Report) would remain subject to rules as proposed and the other rules adopted in the United States to implement Basel Committee standards; including our organizations in the population of "internationally active" banks would only increase these two metrics by 1% to 87% and 93%, respectively.

Indeed, we believe that the Agencies should more fundamentally replace the AA Thresholds. It would be more appropriate—both from a regulatory standpoint and standpoint of Main Street customers who are the focus of the regional banks' business models—to replace the arbitrary,

outdated AA Thresholds with a more risk-sensitive alternative that focuses on business model and risk profile when tailoring regulations. In light of the Agencies' broader effort to review the regulatory capital rules, now is the appropriate time for the Agencies to review and revisit the use of these thresholds.

The systemic indicator score is a more useful and better calibrated measure of the complexity and risk inherent in a banking organization's business model that we and other regional banking organizations have consistently recommended the Agencies consider in lieu of the AA Thresholds.[20] The systemic indicator score was specifically designed to reflect a banking organization's complexity and risk profile based on a weighted average of 12 indicators across five categories correlated with systemic risk—size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity.[21] In contrast to the rudimentary, static AA Thresholds, the systemic indicator score is both more risk-sensitive and dynamic.[22] It is, therefore, a more suitable measure for tailoring the application of the regulatory capital rules, among other prudential standards. The fact that there are banking organizations with assets of less than $250 billion but that are, nonetheless, identified as G-SIBs, using the systemic indicator score further underscores the fact that asset-based thresholds are not an appropriate delineator of risk or complexity. Although we continue to believe extending the Proposal to all institutions would be prudent, if the Agencies determine to limit its scope based on complexity, the Agencies should utilize the systemic indicator score instead of the AA Thresholds to more appropriately align the scope of the Proposal—and regulatory capital requirements more broadly—with banking organizations' business models and risk profiles. Doing so would help support U.S. economic growth while continuing to ensure the safety and soundness of banking organizations and the stability of the U.S. financial system.

C. Extending the Simplifications to Other Banking Organizations is Also Appropriate Because the Deductions for Investments in Unconsolidated Financial Institutions, Temporary Difference DTAs, and MSAs are Overbroad and Unduly Punitive

We believe that extending the simplifications to either all banking organizations or at least all non-GSIBs is appropriate. As currently implemented, the threshold deductions require a banking organization to deduct from its common equity tier 1 ("CET1") capital the amount of its MSAs, significant investments in unconsolidated financial institutions in the form of common stock, and temporary difference DTAs to the extent that the amount (net of associated deferred tax liabilities ("DTLs")) (i) individually exceeds 10% of its CET1 capital, or (ii) in the

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[20] *See, e.g.*, Letter from 10 Regional Banking Organizations to the Agencies Regarding the Proposed Rules to Implement the Basel III Net Stable Funding Ratio (Aug. 5, 2016) (commenting that the scope of the proposal should be tailored to more appropriately reflect a banking organization's complexity and overall risk profile).

[21] *See Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies*, 80 Fed. Reg. 49,082 (Aug. 14, 2015).

[22] The data underlying the systemic indicator score is updated periodically. Bank holding companies with total consolidated assets of $50 billion or more file a quarterly report with the Federal Reserve—the FR Y-15 Banking Organization Systemic Risk Report—which collects data across the five components underlying the systemic indicator score. The aggregate systemic indicators used as the denominators to calculate the score are updated annually.

aggregate 15% of its CET1 capital.[23] The Proposal would raise the limit for the individual deductions to 25% of CET1 capital and would eliminate the aggregate 15% threshold deduction.

The purpose of the deduction for significant common stock investments in unconsolidated financial institutions is to limit the "double counting" of regulatory capital and to protect against interconnectivity and procyclicality.[24] The definition of the term "financial institution" under the regulatory capital rules, however, is broader than necessary to achieve that purpose or to otherwise ensure U.S. financial stability. For example, the definition currently may cover entities that are engaged in activities (such as asset management activities) only as agent, and not as principal. Financial activities conducted as principal, rather than as agent, however, present greater risk—both to the banking organization holding the investment and the broader financial system. In addition, limiting the scope of the definition to entities subject to prudential capital requirements would more appropriately address the "double counting" concerns underlying the deduction. Raising the threshold for this deduction to 25% for all banking organizations would help to offset the unnecessarily broad scope of the definition under the rules.

The current treatment of temporary difference DTAs also is overly conservative. Developments on both the accounting and legislative fronts warrant revisiting the treatment of DTAs for all institutions. First, 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. CECL is broadly expected to increase the levels of loan and lease loss reserves, and therefore DTAs, at banking institutions. Second, reforms being considered by Congress to the U.S. tax code would, if enacted, revise significant aspects of the tax code impacting DTAs for banks. Certain provisions would eliminate tax net operating losses ("NOLs"), resulting in institutions having increased amounts of DTAs subject to the deduction thresholds. If the NOL carryback is eliminated, banks with DTAs (under baseline or in the context of company or supervisory-run stress tests) will experience a significant reduction in their capacity to include temporary difference DTAs in CET1. These developments will significantly impact banking organizations, and may result in unintended but sizable increases in the level of capital that banks with DTAs would be required to hold, given the material effects DTAs have in supervisory stress testing scenarios and in potential future accounting changes. The proposed increase in the current 10% threshold for some institutions, if applied to all banks, as we recommend, would help alleviate some of the risk that institutions in stress would unnecessarily have to deduct excess temporary difference DTAs resulting in increased capital impacts at the exact time when capital is the most expensive and would remove unnecessary procyclicality from the capital rules.

Finally, the treatment of MSAs, assets that are central to mortgage lending in the United States, under the regulatory capital rules is unnecessarily punitive, overstates the risks inherent in these

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[23] 12 C.F.R. § 3.22(d), 12 C.F.R. § 217.22(d) and 12 C.F.R. § 324.22(d).

[24] Basel Committee, *Strengthening the resilience of the banking sector* (Dec. 17, 2009), ¶ 101, *available at* http://www.bis.org/publ/bcbs164.pdf.

assets, and encourages the migration of mortgage servicing out of the banking sector into the shadow banking system. Historically, MSAs could be included in a banking organization's regulatory capital up to 100% of its Tier 1 capital. Therefore, even the proposed treatment—allowing MSAs to be included in regulatory capital up to 25% of CET1—would be conservative.[25] Moreover, MSAs that are not deducted receive a risk weight (250%) that is five times greater than the risk weight for most residential mortgages and two-and-one-half times greater than the risk weight for most other retail and commercial loans under the standardized approach. The proposed change in the threshold deduction for MSAs would, if applied universally to banking organizations subject to the regulatory capital rules, help alleviate some of that impact.

II. Proposed Treatment of High-Volatility ADC Exposures

The proposal would replace the current definition of and risk-weight for high-volatility commercial real estate ("HVCRE") exposures under the standardized approach for determining risk-weighted assets with a new high-volatility ADC ("HVADC") category that would receive a lower 130% risk weight. This revised treatment would, however, not apply to similar exposures under the advanced approaches for risk-weighting assets, where the existing HVCRE concept would remain. The Proposal would grandfather, under the standardized approach, ADC exposures originated before the effective date of the proposed revisions and would apply the proposed definition of HVADC and the proposed lower 130% risk weight only to exposures originated on or after that date. The proposed changes raise several concerns, in particular the proposed requirement for advanced approaches banks to maintain parallel HVADC/HVCRE definitions and systems and the broader scope of the proposed HVADC definition. These concerns and our recommendations are discussed below. More broadly, we support the comments and recommendations of The Clearing House Association L.L.C. and the American Bankers Association related to the HVADC aspects of the Proposal.

The Proposal would broaden the scope of ADC loans subject to an increased capital charge to include certain types of exposures that are unsecured or secured by collateral other than real property. Specifically, because the proposed definition of HVADC exposures is based on the purpose of, rather than the collateral securing, a particular exposure, an ADC exposure that is not secured by real property could be deemed an HVADC exposure if its purpose is primarily to finance ADC activities. The Agencies should, at a minimum, add a collateral-based test to require that exposures deemed HVADC under the Proposal (or, for that matter, HVCRE under current rules) also be secured by real property.

Moreover, the Proposal would establish two separate definitions for ADC exposures for advanced approaches banking organizations. Coupled with the grandfather provisions under the standardized approach, banks like the undersigned regional banking organizations would, therefore, be required to augment systems and track several ADC portfolios, which would add unnecessary complexity (contrary to the goals underlying the Proposal) and would present needless operational and reporting challenges. Instead, the Agencies should use a single

[25] U.S. banking organizations have developed sophisticated risk management systems to appropriately manage the market risks associated with MSAs and also have invested significant sums to enhance mortgage servicing capabilities, particularly in the loss mitigation and default areas.

definition for purposes of the standardized approach and advanced approaches. Moreover, grandfathering of existing exposures under the current definition should not be mandatory. Although grandfathering existing exposures may mitigate burdens for some institutions, e.g., by eliminating the need to re-evaluate existing exposures, for others it may unnecessarily exacerbate operational and compliance burdens. Accordingly, firms should be given flexibility to determine which approach is most appropriate given their specific facts and circumstances.

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The undersigned regional banking organizations thank the Agencies for the opportunity to comment on the Proposal and respectfully ask for consideration of the recommendations and suggestions in this 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 any of the individuals listed in Attachment 1 to this letter.

Sincerely,

Capital One Financial Corporation
The PNC Financial Services Group, Inc.
U.S. Bancorp

Attachment 1

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