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Regulation Comments
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1700 G Street, NW
Washington, DC 20552
Attn: OTS-2009-0015
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RE: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues

OCC: Docket ID: OCC-2009-0012
Federal Reserve System: Docket No. R-1368
Federal Deposit Insurance Corporation: RIN 3064-AD48
OTS: OTS-2009-0015

Ladies and Gentlemen:

The American Bankers Association (ABA) appreciates the opportunity to comment on the above-mentioned proposal related to risk-based capital guidelines of banks. ABA brings together banks of all sizes and charters into one association. ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

The agencies' notice of proposed rulemaking (NPR) would amend the risk-based capital rules in light of two recent Financial Accounting Standards Board (FASB) pronouncements, FASB Statement No. 166 *Accounting for Transfers of Financial Assets,*

an Amendment to FASB Statement No. 140 (FAS 166) and No. 167 *Amendment to FASB Interpretation No. 46(R)* (FAS 167). FAS 166 and FAS 167 remove the concept of a qualified special purpose entity from generally accepted accounting principles (GAAP) and alter the consolidation analysis for variable interest entities (VIEs). The result of these pronouncements will be to significantly limit the ability of banks to recognize securitized assets as off-balance sheet exposures. Many of our members securitize loans and receivables across a spectrum of asset types, including credit card receivables, auto loans, and residential and commercial mortgages and lines of credit. Some of our members also re-securitize assets in a variety of fashions. We believe the vast majority of the assets in these structures will be consolidated onto banks' balance sheets, effective with the implementation of FASB Statement No. 166 and 167 on January 1, 2010.

The agencies note that they have reviewed the regulatory capital rules in light of these changes to GAAP and have proposed two changes to the rules in the NPR.[1] First, the NPR would eliminate the current exclusion of certain consolidated asset-backed commercial paper (ABCP) program assets from risk-weighted assets. Second, the NPR would provide the agencies with a reservation of authority to require banks to treat structures that are not consolidated under the accounting standards as if they were consolidated for purposes of the risk-based capital rules. As further discussed below, the ABA is of the view that the effect of the NPR would be to require higher levels of risk-based capital against certain assets that pose minimal risk to the bank, with the result that overall levels of risk-based capital against securitized assets would be disproportionately higher than the risk posed by those assets. Especially at this stage of the economic cycle, the result would be a procyclical capital charge that would diminish the resurgence of bank lending that is so critical to the restoration of a vital U.S. economy and increase the cost of borrowing for consumers and businesses.

Overall Recommendations

The ABA strongly believes that risk-based capital guidelines should focus on the net relative risk assumed by the organization. This view is consistent with core principle #4 of the Department of Treasury's "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms," which states that "risk-based capital requirements should be a function of the relative risk of a banking firm's exposures, and risk-based capital ratios should better reflect a banking firm's current financial condition…it is crucial that relative risk weights be appropriately calibrated." By translating the GAAP modifications under FAS 166 and FAS 167 directly into the regulatory capital rules, the NPR fails to adequately recognize the difference between contractual and non-contractual risk, as well as the impact of true risk mitigants. For example, the NPR adequately provides for neither the risk-mitigating impact of segregating securitized credit card receivables in a bankruptcy-remote trust, nor the impact of other credit enhancements obtained by the institution. By doing this, the proposal will unnecessarily increase capital requirements, which will greatly inhibit bankers' ability to lend during a time when economic growth is critical.

Our comments and recommendations below are consistent with, and also expand upon, our letter dated June 5, 2009 letter (see Appendix 2). In summary, we believe:

- The implementation of FAS 166 and 167 reflects a conceptual shift of the FASB from one primarily relying on "risk" to one relying on "control". Regulators, however, should consider only the actual net risk that these newly-recorded on-balance sheet assets provide to

1[1] We note that nothing in federal law requires the agencies to adhere to GAAP when determining compliance with regulatory capital requirements. See 12 U.S.C. 1831n.

the organization. Regulatory capital should not be required to reflect risks that have been mitigated by the bank, including through true sales of specific tranches of a securitization or through the purchase of credit protection (for example, the purchase of a credit derivative).

- We do not agree that the amount of capital that should be held against a whole loan should be identical to the capital that should be held against a securitized loan that is subject to limited contractual loss exposure. The agencies should address the possibility that the bank may provide non-contractual support to certain securitization structures by considering various mitigating factors (including past history of non-support and further representation by the institution to withhold non-contractual support). The agencies should also consider applying partial risk-weighting factors (similar to credit conversion factors currently in use for off-balance sheet assets), and dynamic adjustments to those factors through performance-based triggers.

- The agencies' proposal to reverse the exclusion of ABCP conduits from risk-weighted assets would likely have the effect of increasing regulatory capital requirements to an extent disproportionate to the actual, mitigated risks of those conduits. Instead of reversing the exclusion, we recommend that the agencies re-examine the applicable credit conversion factors and the eligibility criteria for ABCP conduits. These must be evaluated, however, in light of the Basel II accord and may consider early adoption of the accord's Internal Assessment Approach as an option.

- We support the agencies' proposal to maintain a reservation of authority, as a mechanism to address situations in which the risk to the bank is not adequately reflected in regulatory capital, to require banks to treat unconsolidated structures as though they are consolidated. However, as we note above, in keeping with the principle that the risk-based guidelines must focus on underlying risk, use of this authority should be applied in conjunction with factors that recognize a difference between contractual and non-contractual risk from a safety and soundness perspective.

- A three-year transition is critical to comply with the additional capital required with the implementation of FAS 166 and 167. To reflect the current economic environment and the limited access of some banks to the capital markets, no additional capital should be required during the first year.

Other Considerations

Investment Funds

While we believe that assets underlying most lending securitizations will now be recorded on the balance sheet, we have not determined whether the billions of dollars of assets in investment funds that are managed for third parties must be recorded on the balance sheet. If so, we believe this is an unintended consequence of FAS 167. However, this issue is still being discussed with auditing firms. In this case, we believe it is inappropriate to provide capital on assets that have never been owned by the bank and have never been considered a financing source. While it is possible these assets certainly may eventually be considered "on-balance sheet", regulatory capital ratios should not be calculated based on them.

Economic Impact and International Competiveness

The new accounting standards will significantly impact risk-based capital ratios and the Tier 1 leverage ratio. Not only may retained earnings be affected, but the denominator of the ratio would include assets that may expose the bank to minimal risk. Limitations on the related allowance for loan and lease losses (ALLL) and deferred tax assets (DTAs) within Tier 2 and Tier 1 calculations compound this effect. With this in mind, we recommend that current limitations on ALLL and DTAs be increased. At this point in the economic cycle, increasing capital requirements will either decrease the amount of lending in the economy or decrease any growth that may otherwise be expected. Not only will this affect the national economy, but it will affect the economic competitiveness of companies that securitize assets.

Preserving U.S. banks' economic competitiveness requires monitoring the convergence of GAAP with International Financial Reporting Standards (IFRS). Changes being contemplated by both the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) would increase the use of mark to market accounting (MTM) for many loans and securities. We understand that the FASB plans to expand MTM treatment are more comprehensive and far-reaching than the IASB proposals, giving rise to international competitiveness concerns for U.S. banks. FASB's proposed MTM treatment of loans that are held for long-term investment would introduce greater volatility in the financial statements of many banks and could increase the cost of capital for U.S. banks because investors generally equate volatility with higher relative risk.

Preserving U.S. banks' competitiveness also requires consideration of Basel II guidelines, as well as any other proposed changes to the regulatory capital rules in light of changes proposed by international bodies. The agencies have been working in both domestic and international forums to address important concerns about the need to improve the quality of Tier 1 capital by including in that measure a greater measure of common shareholders' equity. The call for higher quality Tier 1 capital should be considered in the agencies' assessment of the overall adequacy of regulatory capital to protect a bank against the risk of loss in general, as well as the risk of loss from specific exposures.

Attached are our responses to the detailed questions included in the proposal.

Thank you for considering our response. Please contact me (202-663-4986 or mgullette@aba.com) if you have any questions or would like to discuss these issues in greater detail.

Sincerely,

Michael L. Gullette

Enclosures

Appendix 1: Detailed Responses to Questions

Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Regulatory Capital; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues

Question 1: Which types of VIEs will banking organizations have to consolidate onto their balance sheets due to the 2009 GAAP modifications, which types are not expected to be subject to consolidation, and why? Which types are likely to be restructured to avoid consolidation?

Response:

Variable Interest Entities (VIE's) likely to be consolidated include:

- Debt securitizations in which the master servicer (or sub-servicer) also:
  - Has credit or liquidity guarantee obligations, or
  - Holds equity or significant subordinated tranche securities of the trust.

  These securitizations may be collateralized by loans and receivables (such as residential and commercial loans and mortgages, auto loans, credit card receivables, etc.), bonds, or other asset-backed securities (this normally includes structures which are often referred to as CLO's, CDO's and CMO's).
- Synthetic securitizations, collateralized by a variety of assets.
- Asset Backed Commercial Paper Conduits

Asset managers are also currently working with industry groups and representatives from the large accounting firms to interpret and apply FAS 167 to their investment fund structures, which include:

- Collective investment funds
- Common trust funds
- Separate accounts
- Alternative investment funds
- CDO/CLO funds
- Private equity funds
- Mutual funds
- Money market funds
- Pension funds invested in funds managed by the financial institution.

Investment funds with the following characteristics are at risk for consolidation:

- Seed or start-up capital was contributed and maintained by the manager
- Performance fees, carried interest, or revenue sharing are significant terms of the fund
- Implicit support is provided or assumed

Restructuring expected:

Organizations are currently reviewing structures to determine if restructuring is possible.

Discussion:

We believe that the consolidation of assets of managed investment funds outside of the hedge fund and private equity industries (where performance fee rates are substantial and commonplace) is an unintended consequence of FAS 167. We understand that implicit, non-contractual, support was provided in certain cases to specific funds. However, such support over the past year generally was provided in response to immediate liquidity needs of the investment fund during a time of widespread investor fear that is highly unlikely to recur to the same extent.

We understand that risk-based capital adequacy guidelines were designed to focus principally on broad categories of credit risk.[2] With that in mind, we recommend that any such assets that may be consolidated from managed investment funds be excluded from risk-weighted assets for capital purposes.

In any event, the interpretation of these new accounting standards is in flux and is in some areas ambiguous. Time is needed to understand the full implications of this standard. In the event a delay to the final rule is impractical, we ask that the preamble to the rule include a specific date for subsequent review after there is better and common understanding of how the new accounting standards will be implemented.

Question 2: Are there features and characteristics of securitization transactions or other transactions with VIEs, other SPEs, or other entities that are more or less likely to elicit banking organizations' provision of non-contractual (implicit) support under stressed or other circumstances due to reputational risk, business model, or other reasons? Commenters should describe such features and characteristics and the methods of support that may be provided. The agencies are particularly interested in comments regarding credit card securitizations, structured investment vehicles, money market funds, hedge funds, and other entities that are likely beneficiaries of non-contractual support.

Response:

The Agencies Should Maintain the Principle that Risk-Weighting Should Predominately Reflect the Contractual Risk to the Organization.

We do not believe it is possible to characterize *ex ante* certain classes of transactions as more or less likely to give rise to non-contractual support. The types of transactions that would give rise to a decision as to whether or not to provide support could depend on market conditions and bank-specific considerations at a particular point in time. The decision to provide or not provide support is dependent on a number of factors that do not lend themselves to *ex ante* analysis.

[1] See e.g. 12 CFR Part 208, Appendix A, Section I.

While we understand that banks have provided support outside of contractual obligations, support by one bank does not lead to the conclusion that support is likely to be granted by other banks offering similar products. For example, in the recent past, several credit card issuers supported their revolving trusts, while others chose not to support their trusts notwithstanding downgrades and investor discontent. Accordingly, a "one-size-fits-all" approach that assumes implicit support for particular structures or transactions is an overbroad approach that does not reflect recent experience.

We believe that regulatory risk-weighting should maintain an emphasis on risk. As enumerated in the Department of Treasury's "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Firms" core principle #4: "Risk-based capital requirements should be a function of the relative risk of a banking firm's exposures, and risk-based capital ratios should better reflect a banking firm's current financial condition…it is crucial that relative risk weight be appropriately calibrated." While FAS 167 effectively changes the consolidation criteria from a basis of "risk" to one of "control", we recommend that the agencies resist this and maintain a risk-based capital structure. The plain truth is that assets that are held in third-party hands bear less credit risk to the sponsor/liquidity facilitator than those held by the sponsor/liquidity facilitator. The contractual risk presents credit risk to bank safety and soundness, whereby the risk of implicit support primarily presents operational risk. Erasing this distinction completely up-ends the whole basis of risk-based capital management.

Any Risk of Implicit Support Should Be Evaluated in Light of Various Factors.

We support the risk-based approach utilized in Financial Institution Letter 52-2002 (which requires full risk-weighting for any structure that has been provided non-contractual support). If the institution has indeed provided non-contractual support to a particular type of structure in the past, a partial risk-weighting may be considered for subsequent structures with the same economic characteristics. However, a partial risk-weighting of subsequent structures should be based not only on the provision of past support, but should take into consideration, at a minimum:

- Any differences in the quality of collateral and/or credit enhancements (such as excess spreads),
- The amount of time since non-contractual support was provided to other structures (more recent non-contractual support is a better indicator of future support),
- The dollar amount of assets for which the bank has provided past non-contractual support, and
- The degree to which the institution makes any representations that it does not intend to provide non-contractual support.

If Implicit Support is Deemed Likely, Risk-Weighting Should Reflect the Net Risk.

In those cases in which, after reviewing the factors above, the agencies believe that sufficient risk of implicit support exists to require partial risk-weighting, the agencies should follow the same principles that are generally used today in determining the extent of risk:

- **Only the portion likely to be supported should be risk-weighted:** The amount of implicit support risk should reflect only the maximum amount of support likely to be needed. Therefore, unless the bank has previously supported mezzanine or other non-senior securities, only the senior portion of such securities should be risk-weighted.

- **Credit enhancement obtained by the company must be considered:** The risk weighting should include the effects of credit insurance obtained as part of the structure, as well as credit derivatives that provide credit protection. In essence, as supported by Interpretative Letter No. 988 (Federal Reserve and the Office of the Comptroller of the Currency, April 2004), the risk weighting should reflect the net retained risk, after any credit enhancement obtained by the company that effectively eliminates or reduces the credit risk.

- **Partial risk-weighting should reflect the contingent, non-contractual nature of the risk**: A risk-weighting that is substantially less than the risk-weighting applied to similar "on balance sheet" assets would reflect that the risk of non-contractual support is a contingent risk that may or may not be realized. Of course, once any non-contractual support is provided to a structure or transition, full on-balance sheet risk-weighting then becomes appropriate.

An Implicit Support Trigger Approach Should be Considered.

If the agencies determine that it is appropriate to assess regulatory capital against the contingent risk of non-contractual support, a possible way forward could be to develop implicit support triggers that would give rise to partial risk-weighting of assets. An increase in the risk-weighting may subsequently be triggered (with risk-weightings reflective of any related credit enhancements) by performance (or other events) indicating that the risk of implicit support has increased. These triggers can include:

- A significant decrease in excess spread that may indicate a future early amortization event of a revolving securitization.
- Any decline in the performance of assets beyond initial stress-tested expectations.
- Changes in credit ratings of companies or other vehicles that are providing credit enhancement to the structure.

An example:

To use a simple example, a securitization trust (not an ABCP program) holds $100 million in AAA-rated securities. The bank sponsor of the trust holds a $20 million residual/equity position and has sold $20 million in senior securities and $60 million in mezzanine tranches to the third party funds without contractual support from the bank sponsor. The bank sponsor has also obtained credit enhancement on $10 million of its $20 million residual position, effectively eliminating any credit risk on half of its retained interest. In this scenario, only $10

million of the $20 million retained residual tranche should be risk-weighted. The $60 million mezzanine tranche would not be risk-weighted, since the risk associated with that tranche has is borne by those security holders.

As noted above, there is no contractual support provided to the senior tranches. However, if an implicit support trigger is reached, the likelihood of the bank providing implicit support could be reflected by applying an X% implicit support factor to the 20% risk weighting normally applied to AAA-rated securities held by the sponsor. This results in a risk-weighting equal to X% of the 20%. (We use "X%" at this time to indicate that this percentage can vary)

Summary Recommendation

While we strongly believe that risk-weighting should focus on contractual risks, if the agencies believe risk of implicit support must be provided for, various factors must be considered, recognizing that, from a pure safety and soundness perspective, implicit support inherently carries less risk than contractual support. An analysis of implicit support, if required, should be ongoing and dynamic.

Question 3: What effect will the 2009 GAAP modifications have on banking organizations' financial positions, lending, and activities? How will the modifications impact lending typically financed by securitization and lending in general? How may the modifications affect the financial markets? What proportion of the impact is related to regulatory capital requirements? Commenters should provide specific responses and supporting data.

Response:

Required Capital Levels Will Increase; Capital and Leverage Ratios are also Affected.

As of June 30, 2009, banks reported over $1.8 trillion in outstanding principal balance of loans and other assets sold and securitized with servicing retained. The vast majority of this will be recorded on bank balance sheets as a result of the revisions to GAAP. Of this amount, banks report that their maximum credit exposure is under $200 billion.

Assuming these assets receive typical risk-weighting for risk-based capital purposes, this will increase required regulatory capital by billions of dollars. The increased regulatory capital requirements will adversely affect banks' reported Tier 1 leverage ratios in addition to their risk-based capital ratios. Additional capital is also required because of the following limitations:

- As explained in the response to question 10, many organizations believe retained earnings may decrease due to the accounting for the Allowance for Loans and Lease Losses (ALLL).
- The limited inclusion of the ALLL in Tier 2 capital
- The creation of deferred tax assets (DTAs, arising from the ALLL) and the limited inclusion of DTAs in Tier 1 capital

The current economic climate has placed significant pressure on bank capital. As a result, many banks that will be required to add assets to their balance sheets will need to raise capital in order to meet the risk-based capital and leverage ratios required by the regulators and the markets.

Increases in Required Capital Will Raise the Cost of Capital and May Result in Decreases in Lending.

We believe that banking institutions will respond to the need for increased capital in a variety of ways:

- Certain organizations will need to raise capital through issuing common or preferred stock or subordinated debt. See question 4: a three year transition period is necessary in order to preserve market stability. While certain institutions may have access to (or already have accessed) private equity and subordinate debt sources, scores of companies seeking capital simultaneously will disrupt the market and unnecessarily increase the costs of such capital.

- In the short-term, there is likely to be a continued slow-down in securitization activity, as well as lending in general. This decline in activity, which has been underway in the current economic climate, will be exacerbated by the need for additional capital to support securitization structures. Companies that securitize assets are likely to react to the increases in required regulatory capital by:

    - Either decreasing lending or decreasing the amount of growth in a lending or securitization portfolio.
    - Increasing credit guarantee or liquidity facility fees that are charged to the securitization trusts. This will decrease the yield on these securities. Alternatively, to maintain yield, the rates charged to borrowers on the underlying loans may be increased.
    - Higher loan interest rates will likely decrease the demand for credit, thus hindering economic growth.

Note the procyclical effect of the increased capital requirement. The required increases will slow down lending, which in turn stifles economic growth. A slower economy will increase the likelihood of credit losses, which then lowers bank capital and continues the cycle. While we understand that regulators are targeting higher capital requirements overall, as noted in question 4, we recommend a three year transition period to comply with the increased capital requirements.

Changes in Risk-based Capital Requirements Must be Coordinated with Other Activities.

We urge the agencies to consider the proposed changes to the regulatory capital rules not only in light of the 2009 GAAP modifications, but more broadly in light of other anticipated changes to the regulatory capital rules (including those for "Tier 1 Financial Holding Companies". The agencies have been working in both domestic and international forums to address important concerns about the need to improve the quality of Tier 1 capital by

including in that measure a greater measure of common shareholders' equity. The call for higher quality Tier 1 capital should be considered in the agencies' assessment of the overall adequacy of regulatory capital to protect a bank against the risk of loss in general, as well as the risk of loss from specific exposures.

Question 4: As is generally the case with respect to changes in accounting rules, the 2009 GAAP modifications would immediately affect banking organizations' capital requirements. The agencies specifically request comment on the impact of immediate application of the 2009 GAAP modifications on the regulatory capital requirements of banking organizations that were not included in the SCAP. In light of the potential impact at this point in the economic cycle of the 2009 GAAP modifications on regulatory capital requirements, the agencies solicit comment on whether there are significant costs and burdens (or benefits) associated with immediate application of the 2009 GAAP modifications to regulatory capital requirements. If there are significant costs and burdens, or other relevant considerations, should the agencies consider a phase-in of the capital requirements that would result from the 2009 GAAP modifications? Commenters should provide specific and detailed rationales and supporting evidence and data to support their positions.

Response:

A Three Year Transition is Required to Minimize Market Disruption and for the Agencies to Determine the Appropriate Risk-weightings.

There are significant costs (raising capital, for example, as noted in question 3 above) that would be incurred in implementation of the proposed capital rule, which would be extremely burdensome to banks if the agencies provided only the one-year phase-in contemplated in the preamble to the proposed rule. We also believe that the complexity and interrelatedness of these accounting and capital issues require more careful study by the agencies, including an impact study on the securitization markets and the overall market for bank lending, as these accounting and capital changes can have a significant impact on the overall U.S. economy and prospects for near-term recovery.

With this in mind, we believe a three year transition period be allowed to comply with the new requirements. We have previously noted (see Question 3) that any immediate increase in capital can very likely have an impact on the cost of raising additional capital (which will also affect the affordability of the resulting lending terms). With that in mind, we recommend that, as part of the transition, no transitional increase will be in effect the first year. Therefore, we propose the following schedule:

2010	No increase in regulatory capital
2011	Phase-in of 50% of the regulatory capital requirement for exposures subject to consolidation as a result of the GAAP modifications over four quarters (i.e. 12.5% per quarter)
2012	Phase-in of the remaining 50% of the

regulatory capital requirement for exposures subject to consolidation as a result of the GAAP modifications over four quarters (i.e. 12.5% per quarter)

Question 5: The agencies' request comment on all aspects of this proposed rule, including the proposal to remove the exclusion of consolidated ABCP program assets from risk-weighted assets under the risk-based capital rules, the proposed reservation of authority provisions, and the regulatory capital treatment that would result from the 2009 GAAP modifications absent changes to the agencies' regulatory capital requirements.

Response:

Treatment of Asset-Backed Commercial Paper (ABCP) Programs Should Remain Focused on the Actual Net Risks to the Bank.

As of June 30, 2009, banks reported approximately $20 billion of maximum credit exposure (prior to credit enhancements), and over $200 billion in unused liquidity facility commitments to those structures. ABCP programs are a significant source of financing for many entities. We do not agree with the proposal to eliminate the exclusion of consolidated ABCP program assets from risk-weighted assets under the risk-based capital rules. We believe that risk-weighting for ABCP program assets should be consistent with current regulations, which focus on the risks to the bank. We strongly believe that the weighting should be based only on the contractual exposures of the program, net of any credit enhancements.

As an alternative to including the conduits in risk-weighted assets, if the agencies believe that the risks were not weighted accurately, the agencies should consider re-examining the Credit Conversion Factors (CCF) for "eligible" facilities, or the eligibility criteria itself may be re-examined. This review, however, must ensure that such treatment applied to consolidated conduits be consistent with the effective treatment of the Basel II accord and should consider an option to allow early adoption of the Basel II-based Internal Assessment Approach. In any event, treatment of such assets should remain off-balance sheet for regulatory capital ratios.

Reservation of Authority Should be Retained by the Agencies.

The complex issues involved with securitization and the issues brought on by FASB Statements No. 166 and 167, as well as the ever-changing nature of financial products, make determining the appropriate level of risk a dynamic process. Therefore, we support the proposal for the agencies to maintain a reservation of authority to require banks to treat unconsolidated special purpose entities as if they were consolidated for risk-based capital purposes if the actual risk is not appropriately otherwise reflected. However, as we note above, in keeping with the principle that the risk-based guidelines must focus on underlying risk, use of this authority should be applied only in conjunction with factors that recognize a difference between contractual and non-contractual risk from a safety and soundness perspective.

Question 6: Does this proposal raise competitive equity concerns with respect to accounting and regulatory capital treatments in other jurisdictions or with respect to international accounting standards?

Response:

Both Capital Requirements and Accounting Standards Cause International Competitiveness Concerns.

Any increase in capital requirements for U.S. companies, without a corresponding increase for non-U.S. companies, will cause concerns. The implications of requiring any additional capital should be closely monitored in relation to requirements of the Basel II accord and it is imperative that U.S. companies be spared any competitive disadvantage.

Any disadvantage presented by the proposed increases in required capital should be considered in light of the anticipated disadvantage that U.S. companies will have because of accounting standards that are currently being considered. Current efforts of the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) to converge accounting standards appears, in the short term, to put U.S. banks at a competitive disadvantage to their European competitors. FASB, unlike the IASB, plans to require all loans, no matter the business intent, to be recorded on the balance sheet at fair value. We expect this to add unnecessary volatility to GAAP equity, resulting in higher costs of capital, due to the market's perceived increase in risk.

Question 7: Among the structures that likely will be consolidated under the 2009 GAAP modifications, for which types, if any, should the agencies consider assessing a different risk-based capital requirement than the capital treatment that will result from the implementation of the modifications? How are commenters' views influenced by proposals for reforming the securitization markets that require securitizers to retain a percentage of the credit risk on any asset that is transferred, sold or conveyed through a securitization? Commenters should provide a detailed explanation and supporting empirical analysis of why the features and characteristics of these structure types merit an alternative treatment, how the risks of the structures should be measured, and what an appropriate alternative capital treatment would be. Responses should also discuss in detail with supporting evidence how such different capital treatment may or may not give rise to capital arbitrage opportunities.

Response:

For All Structures, Risk-based Capital Requirements Should Continue to Reflect the Actual Net Risk to the Bank.

For any structure being consolidated, or any sale of assets that no longer qualify as a sale per FAS 166, risk-based capital requirements should be based on the principle that the risk-weightings should be based on underlying substance of risk and not on the form of financial reporting. As we've noted, we believe that FAS 166 and 167 essentially address consolidation of such assets from a "control" perspective and not from a "risk" perspective. Implementation of these accounting standards, however, does not change the underlying risk of these assets to the company. With that in mind, the agencies should continue to base risk-weightings on the following principles:

1. **"Look-through" principle:** Looking through to the underlying collateral (or the underlying guarantee) should provide an appropriate basis for determining risk factors. For example, as noted in question 2, companies that obtain credit enhancements such as mortgage insurance and credit derivatives (such as through synthetic securitizations) should link those positions to their related exposures with the risk weighting inclusive of the effects of the credit enhancement. In essence, as supported by Interpretative Letter No. 988 (Federal Reserve and the Office of the Comptroller of the Currency, April 2004), the risk weighting should reflect the net retained risk, after any credit enhancement obtained by the company that effectively eliminates or reduces the credit risk.

   Certain reported loans that had been transferred and securitized with government sponsored enterprises (GSE) are no longer reported as securities, because the related transfers did not qualify as sales under FAS 166. Looking through to the underlying GSE guarantee would be appropriate in determining the risk-weighting for these securitized loans.

2. **Linking actual exposure to each structure:** Based on the recommendations provided in question 2, for non-senior tranche securities where control and risk have clearly been passed on, the risk weighting of the underlying collateral should reflect the net exposure to the company. For many private-label structures, for example, if a company owns only a residual interest, with no contractual obligation to other tranches, the risk-weighting should reflect only that of the residual tranche.

Question 8: Servicers of securitized residential mortgages who participate in the Treasury's Making Home Affordable Program (MHAP) receive certain incentive payments in connection with loans modified under the program. If a structure must be consolidated solely due to loan modifications under MHAP, should these assets be included in the leverage and risk-based capital requirements? Commenters should specify the rationale for an alternative treatment and what an appropriate alternative capital requirement would be.

Response:

Banks Should Not be Discouraged from Participating in the MHAP Program.

We believe that such servicer activity may require some structures to be consolidated. However, those servicers that participate under the MHAP program should not have to include such assets in the leverage and risk-based capital requirements. It is very possible that modifications under the MHAP program result in a troubled debt restructuring (TDR), often when the loan may have been performing and not expected to default. A "double hit" to capital, for participating in a governmental program, is not appropriate.

Question 9: Which features and characteristics of transactions that may not be subject to consolidation after the 2009 GAAP modifications become effective should be subject to risk-based capital requirements as if consolidated in order to more appropriately reflect risk?

Response: We are aware of no other transactions or structures.

Question 10: Will securitized loans that remain on the balance sheet be subjected to the same ALLL provisioning process, including applicable loss rates, as similar loans that are not securitized? If the answer is no, please explain. If the answer is yes, how would banking organizations reflect the benefits of risk sharing if investors in securitized, on-balance sheet loans absorb realized credit losses? Commenters should provide quantification of such benefits, and any other effects of loss sharing, wherever possible. Additionally, are there policy alternatives to address any unique challenges the pending change in accounting standards present with regard to the ALLL provisioning process including, for example, the current constraint on the amount of provisions that are includible in Tier 2 capital? Commenters should provide quantification of the effects of the current limits on the includibility of provisions in Tier 2 capital and the extent to which the 2009 GAAP modifications and the changes in regulatory capital requirements proposed in this NPR effect those limits.

Response:

The Amount of ALLL Reflected in the Financial Statements will Increase Significantly. Both the numerator and the denominator will be adversely affected in Tier 1 Capital Ratios.

Bankers are currently discussing how to reflect ALLL with their auditors and there are various scenarios that are being considered.

Banks are considering electing the fair value option to account for assets and liabilities consolidated for specific structures. In these cases, there is no ALLL recorded. When the assets are accounted for at amortized cost, however, additional ALLL is recorded and this has significant implications for Tier 2 capital and the related deferred tax assets affect Tier 1 capital. Many bankers believe the new ALLL will adversely affect retained earnings. Therefore, the implementation of FAS 167 impacts not only the denominator aspect of the Tier 1 capital ratios, but also the numerator.

There will be an increase in ALLL related to the implementation of FAS 166 and FAS 167 because of the amount of ALLL related to securitized loans previously reported as securities and accounted for in accordance with FASB Statement No. 115. Whereas in FAS 115, these assets were recorded at fair value (with amortized cost noted), we expect that these assets will now be recorded at amortized cost, with a related ALLL. Further, per paragraph 22A of FAS 167, assets of a consolidated variable interest entity (VIE) will be presented separately from other assets on the balance sheet, and the related ALLL will be included in that amount. Therefore, ALLL related to assets held in third-party hands will also be presented.

Consistent with FASB Statement No. 5 *Accounting for Contingencies*, contingent gains related to extinguishment of the debt issued by the VIE normally occurs only at the time of realization. Therefore, the benefits of the assumption of risk by third-party debt security holders (through contractual loss-sharing "waterfall" agreements) will not normally be recorded until many years after the ALLL is recorded.

In any case, there is expected to be a significant increase in the ALLL, with a large portion of the ALLL having no connection to actual exposure assumed by the company.

The ALLL limitation, as well as the limitation on deferred tax assets (DTAs) in capital calculations should be increased.

With this in mind, we strongly urge the agencies to increase the percentage of the ALLL that is includable within Tier 2 capital. Currently, ALLL is included in Tier 2 capital up to 1.25% of risk-weighted assets, with the excess allowance over the 1.25% cap deducted from risk-weighted assets. Increasing the ALLL limit is appropriate for the following reasons:

- Many companies are already at their limit, so the limits act as disincentives to build up ALLL, which many believe to merely be an alternative form of capital.
- There is no doubt that such limits were made without consideration of these loans being recorded on the balance sheet. With the expected increase in capital required from consolidation, the limits cause a "double hit" to capital.
- The IASB/FASB project to require "expected losses", while not expected to be required before 2012, will result in higher levels of ALLL. We believe that these capital limitations may discourage banks from early adoption (if available) of the new ALLL rules.

Based on these points, we recommend that the ALLL limitation be immediately increased Tier 2 capital purposes and that 100% of ALLL related to risks assumed by third-parties be included in capital.

Since DTAs result when ALLL is recorded, we believe an increase in the amount of DTAs includable in capital is also appropriate (currently, the limitation is the lesser of 10% of Tier 1 capital or the amount to be realized within one year). In addition to that increase already requested in a letter dated September 25, 2009 from the ABA and The Clearing House (see Appendix 3), we further recommend no limit on the inclusion in regulatory capital of DTAs related to ALLL recorded with respect to loans for which the risk of loss has been fully transferred to third parties.

Appendix 2: ABA Letter on June 5, 2009

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Washington, DC 20036

1-800-BANKERS
www.aba.com

World-Class Solutions, Leadership & Advocacy Since 1875

Robert R. Davis
Executive Vice President
Mortgage Markets
Financial Management &
Public Policy

June 5, 2009

The Honorable John C. Dugan
Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

The Honorable Sheila Bair
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

The Honorable John Bowman
Acting Director
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

The Honorable Elizabeth A. Duke
Governor
Board of Governors of the Federal Reserve System
20th and C Streets, NW, (Mail Stop 54)
Washington, DC 20551

The Honorable Daniel K. Tarullo
Governor
Board of Governors of the Federal Reserve System
20th and C Streets, NW, (Mail Stop 54)
Washington, DC 20551

Re: Regulatory Capital Adjustments Required in Response to FASB Sales and Consolidation Accounting Changes

Ladies and Gentlemen:

With the issuance of the amendments to FASB Statement No. 140 ("FAS 140", ***Accounting for Transfers of Financial Assets***) and FASB Interpretation No. 46R ("FIN 46R", ***Consolidation of Variable Interest Entities***) expected in the next few weeks, billions of dollars worth of assets and liabilities that reside in special purpose entities and are currently disclosed in footnotes to the financial statements will now be reported on bank balance sheets. Due to the regulatory impact of this "gross up" of balance sheets, it is critical that banking institutions, as well as the investment community, understand the impact of these changes. Specifically, with a significant increase in assets and liabilities being expected to be recorded on bank

balance sheets, both banks and investors need to understand how the accounting changes will affect the regulatory capital of banking institutions.

The expected changes to FAS 140 and FIN 46R will also have an enormous potential impact on the operations of many banks, whether or not they are involved in securitization activities. New quarterly fair value estimates and analyses of each interest in a variable interest entity, as well as comprehensive consolidation accounting procedures, are just a few of the necessary processes that are not currently in place in the vast majority of institutions. These major new processes could pose operational concerns for banking institutions, especially when considering these companies are required to set these processes up within approximately six months of issuance of the final accounting standard.

We have been in contact with staff at your agencies regarding this matter over the past several months. Whatever the actual regulatory impact may be, we believe it is critical that this guidance coincide with the issuance of the FASB changes in order to avoid unnecessary uncertainty in the markets.

With that in mind, we respectfully submit our recommendations regarding how these changes should be treated for regulatory capital purposes. We believe these recommendations reflect the practical impact of how these changes will affect the safety and soundness of banking institutions.

Recommendations

Look through the reported asset to the underlying guarantee: Because most guaranteed mortgage securitizations will no longer meet the new sales criteria in FAS 140, banks will no longer record such securitizations as securities, but will maintain them on their books as loans. However, whether the securitizations are recorded as loans or as securitizations, once the loans are guaranteed, they should naturally carry a correspondingly lower risk weighting than an unguaranteed whole loan. Therefore, we recommend that regulations "look through" the accounting for the instrument to determine whether the loans are securitized and are guaranteed. If so, those securities reported as loans should carry the same risk weighting as those recorded as guaranteed securities.

Link the assets to the corresponding liabilities of the trust: While the FASB is discontinuing the concept of the qualifying special purpose entity (QSPE), this does not affect the fact that many securitizations are performed through legal trusts where the transferred financial assets have been isolated beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership. The new FASB rules also do not change the fact that loans residing in SPEs to be recorded on the balance sheet will have a significantly different risk profile than those loans directly held by the company. In other words, while the accounting has changed for the assets and liabilities within the SPEs, the risks to the banking institution have not, and, thus, the risk weightings should remain consistent with the substance of the structures.

As one example, loans that are securitized and reside in SPEs will often now be consolidated by the credit enhancer/servicer of the securities (the primary beneficiary). However, the portion held by third parties (through beneficial interests of the related securities) does not subject the primary beneficiary to the same market risks (e.g. interest rate, liquidity) as a recorded whole loan. Those

risks are borne by the security holder. Only if the primary beneficiary holds the security is it exposed to these risks.

With this in mind, we recommend that assets in SPEs that have met the isolation test, along with the corresponding amounts payable to security holders (excluding the credit loss reserve), be linked and excluded from an individual bank's regulatory capital ratios. Regulatory capital should be maintained only for those assets that are retained by the banking institution and subject to claims of its creditors or receiver/conservators. To assign risk weightings to these consolidated assets in a manner similar to risk weightings for whole loans or securities would be inappropriate and arbitrary. Further, a requirement that specific capital be held for the proportionate amount of assets that reside in securities held by others would result in an industry-wide double counting of required capital.

Transition period for any additional capital required: In addition to the operational impact discussed above, the potential impact of these changes on banking regulatory capital is obviously significant – not just to the banks, but also to the economy. With any increase in required capital, a banking institution is likely to reduce the amount of lending using such securitization vehicles, as well as other lending. No matter what the new capital requirements may be, and in consideration of the time required to effectively create and implement such necessary operational processes and to determine and execute alternatives to address any increased regulatory burden, we recommend that the agencies carefully consider whether regulatory changes are necessary from a safety and soundness perspective. If changes are to be required, we recommend that they be phased in over a period of time. Because of the numerous challenges being faced by banking institutions in the current market, we recommend that the transition period be at least three years, with the first year having no regulatory capital impact and the following two years being the time period for implementing the regulatory capital requirements. Such a transition, allowing a bank to "catch up" the incremental capital requirement over a three year period, will allow banks to migrate to alternative procedures and funding without completely halting the markets that rely on securitization.

Thank you for considering our request. Please contact Mike Gullette, ABA's Vice President, Accounting and Financial Management (202-663-4986 or mgullette@aba.com) or me if you have any questions or would like to discuss these issues in greater detail.

Sincerely,

Robert R. Davis

Appendix 3: September 25, 2009 Letter from the ABA and The Clearing House

September 25, 2009

Board of Governors of the Federal Reserve System,
20th & C Streets, N.W.,
Washington, D.C. 20551.

Attention: The Honorable Daniel K. Tarullo,
Governor

Office of the Comptroller of Currency,
250 East Street, S.W.,
Washington, D.C. 20219.

Attention: The Honorable John C. Dugan,
Comptroller of the Currency

Federal Deposit Insurance Corporation,
550 17th Street, N.W.,
Washington, D.C. 20429.

Attention: The Honorable Sheila Bair,
Chairman

Office of Thrift Supervision,
1700 G Street, N.W.,
Washington, D.C. 20552.

Attention: The Honorable John Bowman,
Acting Director

Re: Regulatory Capital Limits on Deferred Tax Assets

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("*The Clearing House*")[1] and the American Bankers Association (the "*ABA*")[2] are writing to urge the Board of Governors

[1] The member banks of The Clearing House are ABN AMRO Bank, N.V., Bank of America, National Association, The Bank of New York Mellon*, Citibank, N.A.*, Deutsche Bank Trust Company Americas, HSBC Bank USA, National Association*, JPMorgan Chase Bank, National Association*, UBS AG, U.S. Bank National Association*, and Wells Fargo Bank, National Association*. Those member banks whose names are marked with an asterisk in the preceding sentence actively participated in the preparation of this letter, including the materials enclosed as Annex 1, and are referred to herein as the "*Participating Clearing House Members*".

[2] The ABA brings together banks of all sizes and charters into one association. The ABA works to enhance the competitiveness of the nation's banking industry and strengthen America's economy and communities. Its members – the majority of which are banks with less than $125 million in assets – represent over 95 percent of the industry's $13.3 trillion in assets and employ over 2 million men and women.

of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency and the Office of Thrift Supervision (together, the "*Agencies*") to revisit the continued appropriateness of the provisions in their risk-based capital guidelines and regulations (together, the "*Capital Regulations*") that limit the amount of deferred tax assets ("*DTAs*") dependent upon future taxable income that may be included in – or, more specifically, not deducted from – a banking organization's regulatory capital. For the reasons discussed further below, The Clearing House and the ABA believe that now is an appropriate time for the Agencies to revisit whether the present limitations on DTAs as set forth in the Capital Regulations continue to be appropriate. We believe strongly that they are not and urge the Agencies either to eliminate the limitations, with the consequence that the Capital Regulations would simply follow U.S. generally accepted accounting principles ("*U.S. GAAP*") in their treatment of DTAs, or at the least significantly relax the existing limitations.

I. Background

Prior to the Financial Accounting Standards Board's adoption of its Statement No. 109, "Accounting for Income Taxes" ("*FAS 109*"), which became effective for fiscal years beginning on or after December 15, 1992, U.S. GAAP did not permit the recording of deferred tax assets that are dependent upon future taxable income. FAS 109 changed U.S. GAAP to require the recording of DTAs that are dependent upon future taxable income, but requires the establishment of a valuation allowance, if warranted, to reduce the DTA net of the valuation allowance to an amount that is more likely than not (i.e., a greater than 50% likelihood) to be realized.

Effective April 1, 1995, the Agencies, in response to the changes in the U.S. GAAP treatment of DTAs brought about by FAS 109, amended the Capital

Regulations to include the current limitations on deferred tax assets.[3] Prior to those amendments, the Capital Regulations did not include a limitation on DTAs. Those amendments provide that DTAs dependent upon future taxable income, net of the valuation allowance, must be deducted from core capital elements in determining Tier 1 capital to the extent that they exceed the lesser of (i) the amount of those DTAs that the banking organization is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, or (ii) 10% of Tier 1 capital.

We believe this is an appropriate time for the Agencies to revisit the treatment of DTAs in the Capital Regulations for two reasons, as follows:

> First, the credit and liquidity crises of the last several years have only heightened the critical importance of regulatory capital as a measure of banking organizations' financial health and strength. The mere passage of time – 17 years since the adoption of FAS 109 and 14 years since the adoption by the Agencies of related amendments to their Capital Regulations limiting DTAs – warrants a re-evaluation of whether the limitations on DTAs are in fact sensible and appropriate. Measures of regulatory capital are not only a critical tool for the Agencies in their supervision of banking organizations; they are also a critical measure monitored by the investor and analyst communities, with distortions to regulatory capital having the potential to likewise distort the perceptions by those communities of the financial health and stability of banking organizations.
>
> Second, the credit and liquidity crises of the last several years inevitably will, and should, lead to a more general re-evaluation of regulatory capital regulations for banking organizations, not only in the United States but

3 The Agencies' proposing and adopting releases appear at 58 Fed. Reg. 8007 (February 11, 1993) and 59 Fed. Reg. 65920 (December 22, 1994), respectively.

internationally. The United States Treasury Department, in its policy statement on capital released on September 3, 2009 entitled "Principles for Reforming the U.S. and International Regulatory Capital Framework for Banking Organizations" (the "*Treasury Policy Statement*"), noted that "the inclusion in regulatory capital of deferred tax assets…should be subject to strict, internationally consistent qualitative and quantitative limits." We understand that the United States is the most restrictive of the G-10 – i.e., those countries whose banking supervisory authorities participate in the Basel Committee on Banking Supervision – in its disallowance of DTAs as a limitation on capital. Pending the convergence on an international standard as part of that re-evaluation, we urge the Agencies to conform the treatment of DTAs under the Capital Regulations so as to be more in line with international standards.

The disallowance from Tier 1 capital of excess DTAs is not an issue only for larger banking organizations. We anticipate that during the next several years it is likely to be at least as constraining, and perhaps more constraining, for community banks and other smaller banking organizations as the resolution of troubled assets "ripples" through the banking system. That is not, of course, a reason for inappropriately relaxing capital standards, whether with respect to DTAs or other components. It is a reason, however, for revisiting whether the limitations on DTAs in the Capital Regulations continue to be appropriate.

II. Discussion

When the Capital Regulations were amended in 1995 to limit the inclusion of DTAs in Tier 1 capital, the comment letters submitted by the banking industry, including The New York Clearing House Association (as The Clearing House was then known) and the ABA, uniformly opposed the limitation and urged the Agencies to simply follow U.S. GAAP. Some of the considerations bearing upon the appropriateness of the

limitation, both pro and con, are the same now as those discussed in 1993/1994; some are different. We have set forth below the considerations that cause us to believe that the limitation decided upon by the Agencies in 1995 should now be eliminated or relaxed.

1. Experience

Banking organizations and their independent accountants have had substantial experience since 1995 with DTAs that are dependent on future taxable income (and, accordingly, the appropriateness of their inclusion in Tier 1 capital), including actual practice in evaluating the need (or lack of a need) for the establishment of valuation allowances under FAS 109 through several credit cycles. We believe experience shows that valuation allowances have been conservatively established and that DTAs net of any valuation allowance that appear on banking organizations' balance sheets under U.S. GAAP are not lesser assets (in terms of realizability) that should be subject to a risk-based capital limitation.

In preliminary discussions that The Clearing House and the ABA have had with the Agencies during the past several months, including meetings with representatives of the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency on May 19, 2009, the Agencies understandably have questioned whether empirical evidence supports that conclusion. An empirical determination of whether DTAs net of any valuation allowance, as reflected on a banking organization's balance sheet as of a particular date, were in fact usable or realizable (and in fact used or realized) against future taxable income, and how quickly, necessarily requires access to granular detail. The granular detail likely would include managements' and accountants' work papers, as to the precise content – by type and transaction – of those DTAs and any related valuation allowances as of a date, followed by a "tracking" of whether and how they were used or realized. That information is not available from public sources, whether periodic reports (including financial statements

included with such reports) filed by public companies with the Securities and Exchange Commission under the Securities Exchange Act of 1934 (the "*1934 Act*"), financial information filed by bank holding companies on Form FR Y-9C, or Call Reports filed by banks with the Agencies.

In the absence of more granular data that is not publicly available, the Participating Clearing House Members and the ABA nevertheless have assembled the information in the tables included as Annex 1[4] from the financial statements and related tax footnotes included in annual reports filed under the 1934 Act for 17 bank holding companies. For each of the 17 bank holding companies, we have included two tables. The first table includes data from 1993 through 2008 and shows: (i) in columns (1) through (3), the bank holding company's DTA (i.e., the DTA net of the deferred tax liability) before the valuation allowance, the valuation allowance, and the DTA after the valuation allowance (the "*Net DTA*"); (ii) in columns (4) through (7), information with respect to current tax expense for the relevant years and whether the future year's or years' tax expense equaled or exceeded the current year's Net DTA within one, two or three years; (iii) in columns (8) through (10), the DTA arising from the loan loss reserve for the current year, the utilization or realization of DTAs by the tax deduction for net write-offs in the current year, and the number of future years that were required for the net write-offs in those future years to equal or exceed the loan loss reserve for the current year; and (iv) in column (11), the net operating loss and tax credit carryforward as of the end of the current year. We focused on comparing the loan loss reserve DTA to tax

[4] The 17 bank holding companies are the holding companies for the six Participating Clearing House Members and six other bank holding companies for which they prepared tables – American Express Company, Fifth Third Bancorp, First Horizon National Corporation, State Street Corporation, SunTrust Banks, Inc. and Zions Corporation. Tables were prepared by the ABA for five bank holding companies which, in accordance with ABA practice, are not identified on the charts but generally are smaller institutions, with the total asset size for each bank holding company as of June 30, 2009 indicated at the top of the first page of the two-page table for such bank holding company.

deductions for net write-offs in columns (8) through (10) because the temporary difference between the U.S. GAAP and the income tax treatments of credit expense is among the items likely to be the most significant during periods of credit stress.

The second table for each bank holding company provides a historical perspective for that bank holding company, setting forth Tier 1 capital before any DTAs disallowed by the Capital Regulations, total risk-weighted assets, total assets, the Net DTA as a percentage of Tier 1 capital, DTAs before deducting deferred tax liabilities or the valuation allowance ("*Gross DTAs*") as a percentage of risk-weighted assets, and Gross DTAs as a percentage of total assets.

The tables show that, since the adoption of FAS 109:

(a) For those bank holding companies that had Net DTAs,[5] current tax expense (reflecting the presence of current taxable income) generally has aggregated to an amount exceeding a prior year's Net DTA very quickly — generally within one year.

(b) For the larger bank holding companies, the year-end DTA related to loan loss reserves generally equaled the actual tax deductions for net write-offs within the subsequent two to three years, but for the smaller bank holding companies the period has been somewhat longer (in one case as many as nine years).

(c) Predictably the DTA related to loan loss reserves (in column (8) of the first table) as well as the tax deduction for net write-offs rose substantially in 2008. It is important to note that both items increased, the implication being that

[5] A number of the bank holding companies had net deferred tax liabilities instead of net DTAs for many of the years in the period, including the down years in the credit cycle.

> the disparity between the U.S. GAAP and the income tax treatments of credit expense does not necessarily increase during the down period in economic cycles because write-offs occur and tax deductions are realized within a reasonable period after provisions are taken to increase the loan loss reserve.

With respect to how the Agencies might access the more granular data that would be most useful for an empirical analysis, we understand that the Agencies are making inquiry of the major accounting firms, including the "Big Four" (Deloitte & Touche, Ernst & Young, KPMG, and Pricewaterhouse Coopers), concerning their experience as independent accountants' in auditing financial statements and reviewing clients' DTAs and the need for related valuation allowances since the adoption of FAS 109. We encourage those discussions. Although banks (including the Participating Clearing House Members) would not generally be willing to share with competitors their own granular data, each of the Participating Clearing House Members would be willing to meet with representatives of the Agencies, along with their independent accountants, to discuss confidentially the details of their individual DTAs and related valuation allowances.

2. Rulemaking by Exception

Rules and regulations, as an objective, should be of general applicability and work without a need for frequent one-off exceptions. During the past year, however, the Federal Reserve on three occasions has accorded DTA capital relief to large banking organizations in connection with acquisitions of troubled institutions: by letter dated December 22, 2008 to PNC Financial Services Group, Inc. in connection with its acquisition of National City Corporation; by letter dated February 20, 2009 to Wells Fargo & Company in connection with its acquisition of Wachovia Corporation; and by letter dated March 30, 2009 to Bank of America Corporation in connection with its acquisition of Merrill Lynch & Co. Incorporated. The need for these three bank holding

companies to seek DTA capital relief, and the Federal Reserve's determination to grant the relief sought, indicate the need for a more comprehensive re-evaluation of the Capital Regulations' treatment of DTAs and the constraint that that treatment can have on acquisitions of troubled entities at a time when acquisitions should be facilitated where possible.

3. Capital Regulations Assume Banking Organizations Are Going Concerns

One of the arguments that the banking industry made in 1993/1994 was that the Agencies' concern with respect to the usability or realizability of DTAs against future taxable income was, although not misplaced, likely overstated given the core premise of the Capital Regulations. The Capital Regulations are premised upon banking organizations as going concerns, not failed entities, and accordingly the concern that there will never be future taxable income against which deferred tax assets could be used or realized should not be the major concern. That premise as applied to DTAs, unlike the scope and application of the Capital Regulations more generally, was rejected in the Agencies' determination to amend the Capital Regulations in 1995. We strongly urge the Agencies to reconsider their view. Moreover, we note that the banking organization failures (or near failures, resulting in forced mergers) in the current financial crisis have for the most part not resulted from periods of losses or low earnings (whether relating to asset quality concerns or otherwise) or even expectations of sustained future periods with no earnings but, instead, from liquidity crises.

4. Loss of DTAs in Mergers and Acquisitions

One of the concerns the Agencies raised at the time of adoption of the existing Capital Regulation limitations was with the possible loss of DTAs dependent upon future taxable income due to the limitations on net operating loss carryforwards under Section 382 of the Internal Revenue Code if a change in control occurs. The

Clearing House and the ABA respectfully submit that that should not be a major concern because the context in which the loss of carryforwards most commonly would arise is in an acquisition subject to regulatory approval. The relevant Agency will have an opportunity to assess capital adequacy at the time in evaluating whether or not to grant approval. In addition, under current purchase accounting rules acquiree DTAs are revalued and closely scrutinized.

III. Proposal

The Clearing House and the ABA believe that the Capital Regulations should simply follow U.S. GAAP in their treatment of DTAs, including those dependent upon future taxable income, and not treat DTAs dependent upon future taxable income as "lesser assets" (or assets the future realization of which is in doubt) that are analogous to intangible assets the value of which can decline or disappear, even for a going concern. Accordingly, we strongly urge the Agencies to commence a formal rulemaking to eliminate the current limitation in the Capital Regulations on DTAs dependent upon future taxable income.

If the result of the Agencies' own investigation as well as comments made during a formal rulemaking ultimately do not, in the Agencies' view, support simply conforming the treatment of DTAs in the Capital Regulations to U.S. GAAP, we strongly urge the Agencies to consider other alternatives that do not require a 100% capital charge for excess DTAs. Those alternatives could include one or more of: (i) meaningfully extending the current one-year "look forward" period during which banking organizations currently must expect to realize DTAs that are not disallowed; (ii) meaningfully increasing the 10% of Tier 1 capital limit on DTAs that are not disallowed; or (iii) instead of requiring a deduction in calculating Tier 1 capital of 100% of DTAs dependent upon future taxable income that exceed the more restrictive threshold, require a deduction of 50% of such excess DTAs.

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
Office of the Comptroller of Currency
Office of Thrift Supervision

* * *

The Clearing House and the ABA would be pleased to discuss with the Agencies the enclosed charts and the views expressed in this letter. Please direct any questions to Joseph R. Alexander, Senior Vice President and Senior Counsel of The Clearing House, 212-612-9234, and Fran Mordi, Vice President and Senior Tax Counsel of the ABA, 202-663-5317.

Very truly yours,

The Clearing House Association L.L.C

Joseph R. Alexander
Senior Vice President
and Senior Counsel

Very truly yours,

American Bankers Association

Robert R. Davis
Executive Vice President