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October 15, 2009

*Via Electronic Mail*

Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington, DC 20219
Regs.comments@occ.treas.gov
Docket No. OCC-2009-0012

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551
Regs.comments@federalreserve.gov
Docket No. R-1368

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Comments@fdic.gov
RIN # 3064-AD48

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Regs.comments@ots.treas.gov
Attention: OTS-2009-0015

Re: Notice of Proposed Rulemaking: Risk-Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance; Impact of Modifications to Generally Accepted Accounting Principles; Consolidation of Asset-Backed Commercial Paper Programs; and Other Related Issues. 74 Fed. Reg. 47138 (Sept. 15, 2009).

Dear Ladies & Gentlemen:

Pepper Hamilton LLP appreciates this opportunity to comment on the above cited Notice of Proposed Rulemaking (the "Proposal"), proposed by the addressees (the "Agencies"). Pepper Hamilton LLP is a law firm which represents financial institutions in connection with financial services regulatory concerns. The views expressed herein are based upon our

representation of regional and community banks, including several credit card issuing institutions (collectively, the "Institutions"), as well as upon our views of the issues that these Institutions will face under the Proposal.

The Institutions have significant concerns regarding the Agencies' proposal. First, the Institutions are concerned with, among other things, the effect of the Proposal on required risk-based capital levels, and the effect of such required capital levels on the credit and securitization markets. Specifically, the Proposal likely will require banking organizations to consolidate previously securitized assets onto their balance sheets, and it would further require increased risk-based capital levels. This will clearly discourage activity in the debt-securitization markets at a time when such activity is most needed because these markets play a crucial role in financing corporate loans, home mortgages, credit cards, student loans, and consumer spending. As credit generated from the securitization markets is the fuel that drives economic recovery, the widespread elimination of such credit that the Proposal will cause will stall and even worsen the lingering recession. This vital link of the success in the securitization markets to the availability of credit and economic growth was recently stressed by Joseph R. Mason, a professor of banking at Louisiana State University: "Given the imperative for securitization markets to fuel bank lending, we won't have meaningful economic growth until securitization markets are re-established."[1]

Second, the Institutions are concerned that the Agencies have failed to recognize the full import of the General Accepted Accounting Principles ("GAAP") modifications. While the impact of the FAS 166/167 modifications requires consolidation of off-balance sheet items, FAS 167 in part also provides for separate classification of those consolidated assets and liabilities that do not increase risks to the consolidating banking organization. Although embracing aspects of GAAP that require enhanced capital levels, the Agencies have neglected to fully incorporate the provisions of FAS 167 which recognize the lesser risk of some assets and liabilities by providing a separate classification for those assets and liabilities. By adopting FAS 166/167 selectively, the Agencies are proposing to apply a fragmented accounting structure for purposes of determining the appropriate capital levels. The Agencies' piecemeal incorporation of GAAP into their proposed capital rule, will leave conspicuous gaps in any risk-based capital requirements. In view of this obvious regulatory flaw, we urge the Agencies to issue a second notice of proposed rulemaking fully incorporating FAS 167.

[1] "A Thirst for Credit," The New York Times (October 7, 2009).

## Background

On June 12, 2009, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards No. 166, *Accounting for Transfers of Financial Assets, an Amendment of FASB Statement No. 140 (FAS 166)* and Statement of Financial Accounting Standards No. 167, *Amendments to FASB Interpretation No. 46(R) (FAS 167)*. FAS 166 and FAS 167 removed the concept of a qualifying special purpose entity ("QSPE") from GAAP and altered the consolidation analysis for variable interest entities ("VIEs") that are not consolidated under current GAAP requirements.[2] As noted in the Proposal, these changes will require some banking organizations to consolidate the assets, liabilities, and equity of certain VIEs onto their balance sheets for financial and regulatory reporting purposes.[3]

## Discussion

*Harm to Administration's Goal of Restarting Securitization Markets*

The Proposal would stall and perhaps even harm the securitization markets. Indeed, the Proposal is contrary to the explicit financial policy goals as articulated by President Obama, senior Administration officials, the Federal Reserve Chairman, and Congressional leadership. For example:

- **President Barack Obama:** In an April 19, 2009 speech on the economy at Georgetown University, President Obama noted in describing the Administration's recovery plan: "Our program to support the market for auto loans and student loans has started to unfreeze this market and securitize more of this lending in the last few weeks. And small business(es) are seeing a jump in loan activity for the first time in months."[4] In a brief question and answer session following the Georgetown speech, President Obama said: "[W]e're going to have to

[2] 74 Fed. Reg. 47138, 47140 (Sept. 15, 2009).

[3] *Id.*

[4] The full text of the President's speech can be obtained through the White House Press Office, or online at: http://www.whitehouse.gov/the_press_office/Remarks-by-the-President-on-the-Economy-at-Georgetown-University/ (last visited October 9, 2009).

figure out what we do with the nonbanking sector that was providing almost half of our credit out there. And we're going to have to determine whether or not as a consequence of some of the steps that the Fed has been taking, the Treasury has been taking, *that we see the market for securitized products restored*."[5] (emphasis added)

- **Treasury Secretary Timothy Geithner:** On February 10, 2009, in unveiling the Administration's Financial Stability Plan, Secretary Geithner said: "No financial recovery plan will be successful unless it helps restart securitization markets for sound loans made to consumers and businesses – large and small."[6]

- **Federal Reserve Chairman Ben Bernanke:** On September 15, 2009, in a question-and-answer session following a speech given at the Brookings Institution, Chairman Bernanke said: "So my forecast would be that the shadow banking system, securitization markets, will come back, they'll be a substantial part of the U.S. credit system[.]"[7]

- **Senator Jack Reed:** Senator Jack Reed (D-RI), chairman of the Senate Banking Subcommittee on Securities, Insurance and Investment, said: "Our challenge is to have a robust securitization process that adds value to the economy and doesn't undermine it."[8]

- **Lee Sachs:** Lee Sachs, a counselor to Secretary Geithner, has stressed: "It's very important that [the securitization] markets come back to get

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[5] "After the Great Recession," New York Times (May 3, 2009).

[6] Secretary Geithner Introduces Financial Stability Plan, TG-18 (February 10, 2009) (available at: http://www.treasury.gov/press/releases/tg18.htm) (last visited October 9, 2009).

[7] The full text of Chairman Bernanke's speech and comments is available at: http://www.brookings.edu/~/media/Files/events/2009/0915_financial_crisis/20090915_bernanke.pdf (last visited October 9, 2009).

[8] "A Thirst for Credit," The New York Times (October 7, 2009).

credit to businesses and families who need it, and also as a sign of confidence."[9]

- **Lawrence Summers:** Larry Summers, former Treasury Secretary and current director of the White House National Economic Council, said that "substantial repair in the financial markets" has led to lower credit costs, more fluid securitization markets and lower mortgage rates for those looking to refinance or buy a home.[10]

It is clear from the sampling of comments above, that any regulation that hampers the restarting of the securitization markets is inconsistent with the policy objectives that President Obama, Secretary Geithner, Chairman Bernanke, National Economic Council Director Summers, and others are attempting to implement. The current Proposal threatens to turn back the clock on the gains that have already been made in this still fragile economy. In fact, renown Yale University economist and housing expert, Robert J. Shiller, who predicted the subprime collapse, has stated recently: "The securitization markets are dead . . . . We're stuck."[11] The Agencies' current proposal does nothing to revive the markets.

As discussed below, while we understand the Agencies' goals in considering the proposed issues, we believe that, as drafted, the Proposal is ill-suited in the current economic environment and may indeed cause more uncertainty and adverse consequences than the Proposal was designed to remedy.

*GAAP as the Standard for Determining Risk-Based Capital*

The Agencies "use [GAAP], as established by FASB, as the initial basis for determining whether an exposure is treated as on, or off-balance sheet, for regulatory capital purposes."[12] However, deferral by the Agencies to GAAP is problematic for several reasons.

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9 *Id.*

10 "White House Officials Upbeat on Economy Ahead of Obama's Speech," Foxbusiness.com (September 11, 2009) (available at: http://www.foxbusiness.com/story/markets/white-house-officials-upbeat-economy-ahead-obamas-speech/) (last visited October 9, 2009).

11 "A Thirst for Credit," The New York Times (October 7, 2009).

12 74 Fed. Reg. at 47140.

First, GAAP is still being debated, and the appropriate tailoring of its standards to current market conditions is being refined. Second, the GAAP approach tends to be pro-cyclical, which is inappropriate in a time of recession, and may not reflect the prudent capital levels for such a point in the business cycle. Third, the appropriate levels of allowances for credit loses that are required by safety and soundness principles will not necessarily comport with GAAP requirements.

While the Agencies' Proposal notes that it relies on GAAP as the foundation for the regulatory capital consolidation determination, the Agencies have failed to acknowledge the entirety of the 2009 GAAP modifications, specifically certain crucial provisions of FAS 167. FAS 167 provides for separate classification of assets and liabilities reflecting the inherent risklessness to the consolidating institution posed by those separately classified assets and liabilities. In the Agencies' failure to acknowledge that separately classified assets and liabilities should be either excluded from capital ratios or given a zero risk weight, the Proposal does not take into account the inherent risklessness to the consolidating institution of separately classified assets and liabilities. The Agencies have in effect cherry-picked those aspects of the GAAP modifications that tend to require consolidation and hence additional capital, while ignoring those provisions of the GAAP modification that would permit a banking organization to separately classify assets and liabilities based on risk. The Agencies should avoid this seemingly arbitrary regulatory approach and instead defer to GAAP in its entirety if they are to do so at all.

*Reservation of Agency Authority*

In the Proposal, the Agencies note that they "expect that there may be instances when a banking organization structures a financial transaction with a [special purpose entity] to avoid consolidation under FAS 166 or FAS 167, and the resulting capital treatment is not commensurate with the actual risk relationship of the banking organization to the entity."[13] Because of this concern, the Agencies have proposed to retain the authority to require banking organizations to treat an entity as if it were consolidated onto the banking organization's balance sheet for risk-based capital purposes – even when GAAP would not require such consolidation.[14]

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13 *Id.* at 47144.

14 *Id.*

The Institutions oppose the Agencies' proposal that they reserve the authority to depart from a strict application of the consolidation requirements of FAS 166 and FAS 167 on an ad hoc, agency-by-agency, basis. Instead, the Institutions believe that greater predictability through clearer, uniform standards should be required for the exercise of any reserved authority. Specifically, the Institutions suggest that the Agencies consider adopting a uniform standard for determining when consolidation and risk weighted factors will be utilized for regulatory risk-based capital purposes when GAAP does require consolidation, as well as specify the standards governing when the Agencies will use their discretion waiving such requirements.

Uniform, predictable capital rules enable banking organizations to better forecast their capital requirements, and plan accordingly. However, the ad hoc approach that the Agencies have proposed will create many inconsistencies developing across the Agencies as to the specific capital requirements, with the possibility that one agency might follow GAAP and not require additional capital, and another agency might require it – for the same bank, or for two similarly situated banks. Furthermore, the two agencies may decide on differing levels of additional regulatory capital. This likelihood of inconsistent and contradictory treatment by the Agencies would be unfair to the banking organizations they supervise and would result in poor regulatory policy.

*Critical Necessity for a Uniform Regulatory Standard if FAS 167 is Not Incorporated*

Banking organizations covered by the Proposal should be afforded the opportunity to rebut any presumption of the need to increase risk-based capital as a result of consolidation under GAAP. Under FAS 167, GAAP itself provides a mechanism for separately classifying riskless assets, even where consolidation is otherwise required under GAAP. By refusing to fully incorporate FAS 167 into the Proposal, the Agencies have omitted an existing standard for evaluating the risk of securitized assets and liabilities. This omission may cause banking organizations to question whether the goal of the Agencies is in fact to account for risk, or merely to increase capital regardless of actual risk.

*Rebuttal of Requirement to Raise Additional Capital*

If the Agencies decide to selectively incorporate FAS 166/167, by ignoring the risk classification provisions of FAS 167, which implicitly recognize risklessness, then they should, at a minimum, consider developing their own uniform approach for banks to rebut a presumption of the need to increase capital when assets are consolidated back onto the bank's balance sheet. Under this suggested approach, once a determination has been made that GAAP requires off-balance sheet items to be consolidated, the Agencies would then evaluate whether

the banking organization, through implicit, non-contractual support, may have exposed itself to added recourse obligations and therefore has incurred greater risk that might warrant the enhanced capital requirement. Possible factors to be considered by the Agencies in reviewing such a rebuttal might include: (a) the banking organization's previous history of implicit support of similar structures; (b) whether the banking organization has provided credit enhancements; and (c) whether the banking organization has publicly and in a legally binding manner, disavowed any implicit support for the particular securitization. In applying this approach, where the banking organization sufficiently rebuts the presumption of implicit support, there would be no expectation or possibility of future support (without regulatory approval), and therefore no need for enhanced capital requirements.

*Bifurcated Standard*

We request that the Agencies consider adopting a bifurcated approach to evaluating the need for consolidation for regulatory capital purposes. This bifurcated approach could distinguish between larger institutions with greater risk profiles, and smaller institutions with less risky profiles. We believe that requiring enhanced capital levels for all institutions that meet consolidation standards (either under GAAP or based on a regulatory determination) is inherently over-inclusive and unnecessary. In developing this bifurcated approach, the Agencies should consider such factors as: size of the institution, history of securitizations and performance of such securitizations, and a sampling of the status of the underlying assets in the securitization. This sampling approach will enable the Agencies to "look-through" the securitization to evaluate whether the underlying individual assets and liabilities warrant enhanced risk weighting.

Such a bifurcated approach would not be an anomaly for the supervisory process. For example, in their institution-specific supervisory examinations, the Agencies already recognize that cycles of normal-course supervisory examinations can be tailored to the specific profiles of the institution and that the scope and frequency of supervisory examinations may vary based on predetermined criteria applied to specific institutions.

*Detrimental Effect of the Proposal*

The GAAP modifications will have the effect of artificially increasing the number of assets and liabilities that are in fact not owned by the banking organization. If the Agencies adopt the Proposal in its current form without the possibility of granting relief from the regulatory capital requirements that consolidation might bring, the resulting required capital levels will impede the restarting of the securitization markets. The scarcity of capital and the stalling of the securitization markets has the potential for a devastating impact on American

families who rely on the securitization markets to facilitate the availability of loans that they need for home mortgages, education loans, and consumer goods such as groceries, home appliances, furnishings, and automobiles. As long as the securitization market remains stalled, which the Proposal will artificially prolong, banks will be reluctant to make loans because they effectively will have to hold onto such loans instead of liquidating them as securities. In short, because the Proposal will require banks to increase their required capital holdings, securitizations will decrease, which will cause a contraction in the credit markets, which will cause a slow-down and possible downturn in economic growth and a sustained recovery.

*Transition Period/Phased-In Implementation*

A transition period will be necessary for banking organizations to review and implement any capital requirement that becomes effective through the final rule that is promulgated as a result of the Proposal. The Agencies' proposed four-quarter phase-in period suggested in the Proposal,[15] however, is insufficient to provide an orderly and efficient transition to the new guidelines. Requiring banking organizations to implement a final rule during a four-quarter period would force them to raise additional capital in a very short period of time and at an extremely high cost. In fact, as FAS 166/167 are effective as of the beginning of a banking organization's first annual financial statement reporting period that begins after November 15, 2009,[16] for banking organizations whose fiscal year begins in November or December, GAAP will need to be implemented immediately, which will require those banks to begin raising capital immediately – at a substantial cost. Further, and particularly as applied to banking organizations engaging in securitization of credit card receivables, as the majority of existing credit card structures are expected to mature during the next three years through December 12, 2012, a three-year phase-in period will be more appropriate.

Delaying the effective date of the Proposal will also allow the Agencies the opportunity to determine whether FASB makes any additional changes to GAAP. Additionally, the Agencies should consider combining a moratorium on the application of the GAAP modifications to regulatory risk-based capital calculations, followed by a phase-in schedule. The moratorium would provide the Agencies with the opportunity to ascertain the risks from consolidation, and to evaluate the effects of changing the capital requirements before

[15] 74 Fed. Reg. at 47143.

[16] 74 Fed. Reg. at 47140.

implementation of a final rule. Once the moratorium had concluded, and the Agencies have had adequate time to consider the likely effects of the modified GAAP and the changes made by the Proposal, then a phased-in period would follow.

*Proposal's Specific Questions for Comment*

We have reviewed the comments filed to date by other commenters in response to the Proposal's specific requests for comment, and believe such responses to be quite deliberative, thoughtful, and insightful with respect to the questions raised by the Proposal. On those specific questions, we add nothing further to the record created to date, except as noted below. However, given the breadth of the topics that the Agencies have raised, we believe that the Agencies should carefully consider the many comprehensive comment letters that have been submitted as part of this complex rulemaking. Further, we believe that in analyzing the various insights and suggestions offered through the comment process, the Agencies should allow for ample time to carefully consider the comments provided, as well as the extensive record that will have been developed, and engage in additional research as needed. Only after the Agencies have reviewed the record, and considered, addressed, and where appropriate, incorporated the commenters' suggestions, should the phased-in implementation period begin.

*Additional Issues for the Agencies' Consideration*

The Agencies' very thoughtful questions posed in the Proposal suggest other questions, as well as further data and research that should be considered and added to the record before finalizing how the Agencies intend to address the challenging issues raised by the Proposal. Based upon the Institutions' experience with the securitization markets, we suggest that the Agencies consider the following additional issues.

- Based upon their own experience, the Institutions believe that not all banking organizations have adjusted to FAS 166/167, particularly regional and community banks. Have the Agencies considered, either through empirical research or otherwise, what effect FAS 166 and 167 will have on regional and community banks?

- Have the Agencies ascertained whether a 100 percent risk weighting on securitized assets is appropriate when such assets have been legally sold without legal recourse to the issuer/seller?

- The Proposal seems to suggest that loans, which have been brought back onto the balance sheet as loans, would require higher loan loss reserves. Have the Agencies considered whether it would be more appropriate for the items to be brought back onto the balance sheet as in fact being securities that are marked to market?

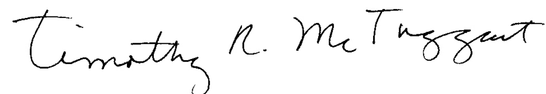
## Conclusion

As discussed above, while the Institutions share the Agencies' goal of promoting greater financial statement transparency and integrity, the Institutions believe that any gains toward advancing such goal would be largely offset by damage to the securitization market and by hindrances to future economic growth. Further, the Institutions believe that the appropriate regulatory capital treatment is to continue to require regulatory risk-based capital and leverage ratio treatment for only the variable interest retained and not for all of the consolidated VIE assets. If the Agencies decide to apply the GAAP modifications to their risk-based capital determinations, we strongly believe that adopting GAAP in its entirely, rather than selectively, coupled with a bifurcated approach taking into account the size and history of the institution, among other factors, is essential. Finally, given the critical importance of the securitization markets to the viability of the American economy, and the livelihood of American families, as well as the very complicated nature of the important issues presented in the Proposal, we urge the Agencies to consider a final rule that requires the Agencies to undertake a demonstrable risk analysis of the securitizations being reviewed, and to implement such a final rule only after very careful deliberation as to the effects of the rule.

We appreciate this opportunity to share with the Agencies the Institutions' concerns regarding this important issue, the effects of which will have wide-spread ramifications not only for the banking organizations directly covered by the Proposal, but for all Americans.

Should you have any questions regarding the discussion above, please do not hesitate to contact me at (202) 220-1210, or my colleague, Travis P. Nelson, at (215) 981-4187.

Sincerely,



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