American Bankers Association
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Jennifer J. Johnson, Secretary
Board of Governors of the
Federal Reserve System
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Washington, D.C. 20551

Office of the Comptroller of the Currency
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Mail Stop 2–3
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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Comment on Joint Notice of Proposed Rulemaking Regarding Establishment of a Risk-Based Capital Floor; Board Docket No. R-1402; OCC Docket No. 2010-0009; FDIC RIN 3064-AD58

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the Joint Notice of Proposed Rulemaking (proposal) to implement provisions of Section 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) regarding the establishment of a risk-based capital floor.[2] The proposal resolves some of the questions presented by Section 171 but, as discussed below, leaves unanswered certain important questions that will need to be addressed.

Summary of the Proposal

The proposal implements the requirement in Section 171 to amend the "advanced approaches rules"[3] by changing the minimum risk-based capital that institutions subject to the advanced approaches rules must hold.[4] The minimum risk-based capital requirements are to be

[1] The American Bankers Association represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. The majority of ABA's members are banks with less than $165 million in assets. Learn more at www.aba.com.

[2] 75 Fed. Reg. 82317 (Dec. 30, 2010) (the proposal).

[3] As stated in the preamble to the proposal, "The advanced approaches rules incorporate a series of proposals released by the Basel Committee on Banking Supervision …, including the Basel Committee's comprehensive June 2006 release entitled 'International Convergence of Capital Measurement and Capital Standards: A Revised Framework' …." 75 Fed. Reg. at 82318.

[4] Section 171 also imposes minimum leverage capital requirements. However, the proposal focuses solely on the risk-based capital requirement of Section 171.

no less than "generally applicable risk-based capital requirements" and may not be quantitatively lower than the generally applicable risk-based capital requirements in effect for insured depository institutions as of July 21, 2010. The term "generally applicable risk-based capital requirements" is defined in Section 171 as follows:

> (A) the risk-based capital requirements, as established by the appropriate Federal banking agencies to apply to insured depository institutions under the prompt corrective action regulations implementing section 38 of the Federal Deposit Insurance Act, regardless of total consolidated asset size or foreign financial exposure; and
>
> (B) includes the regulatory capital components in the numerator of those capital requirements, the risk-weighted assets in the denominator of those capital requirements, and the required ratio of the numerator to the denominator.

The proposal notes that institutions that are subject to the advanced approaches rules could, under those rules, hold capital in amounts less than would be required under the generally applied risk-based capital rules. Given that Section 171 prohibits that outcome, the agencies have proposed to amend the capital floors that apply to the advanced approach institutions.

Banks and holding companies that are subject to the advanced approaches are required to maintain a total risk-based capital ratio of at least 8.0 percent and a tier 1 risk-based capital ratio of at least 4.0 percent. The agencies propose to implement Section 171 by requiring advanced approaches institutions to measure compliance with these minimums by computing capital under the advanced approaches rules and under the capital rules that apply to banks that are not required to use the advanced approaches, and then comparing the lower of the two to the 8.0 percent and 4.0 percent regulatory minimums.

Under the proposal, an institution's tier 1 risk-based capital ratio is the lower of an institution's tier 1 capital to total risk-weighted assets as calculated under the advanced approaches and its tier 1 risk-based capital ratio as calculated under Basel I. In other words, the "official" tier 1 ratio would be the lower of Basel I tier 1 capital and tier 1 under the advanced approaches separately calculated. Thus, it appears that the NPR could effectively lower an institution's capital for purposes of complying with the advanced approaches. As discussed below, this goes beyond what the Dodd-Frank Act requires.

The proposal contains flexibility for a bank to use the risk weight categories applicable under the capital guidelines for bank holding companies if (a) the bank holds the asset solely under the "debt previously contracted" (DPC) authority or similar authority and (b) the risks associated with the asset are substantially similar to the risks of assets that are assigned to a risk weight category of less than 100 percent.

The remaining changes phase in Section 171's restrictions on the regulatory capital treatment of debt or equity instruments issued before May 19, 2010, for certain institutions.

Discussion

ABA is concerned that the regulation as proposed requires more than the Dodd-Frank Act mandates and would result in an inappropriately conservative capital regime. When Basel III is finalized in the U.S. for the advanced approaches banks, these banks should not have to hold capital computed under the Basel I rules at levels sufficient to meet the Basel III minimums. Instead, advanced approaches banks should meet Basel I requirements using a Basel I framework and meet Basel III requirements using a Basel III framework. Otherwise, these banks could face the worst of both worlds in the form of higher capital minimums and more conservative rules used to determine compliance. This would create a significant competitive disadvantage for U.S. banks and is neither required by, nor consistent with the intent of, Section 171. Moreover, it would not be consistent with the intent of either Basel I or Basel III.

The following example illustrates the potential problem.

Example of Capital Floor under the NPR's interpretation of Section 171 of Dodd-Frank: Taking "the lower of" for Basel III compliance for the U.S. advanced bank *

	Bank A Basel I	Bank A Basel III	NPR for Bank A	Foreign Bank B
Tier 1 Capital	**75**	**75**		**75**
RWA	**925**	**850**		**875**
Computed Ratios				
Tier 1 Capital/RWA	8.11%	8.82%	**8.11%**	8.57%
STANDARDS				
Well-capitalized Tier 1 (PCA) required	6.00%			
Basel III minimum Tier 1 Capital/RWA		8.50%	**8.50%**	**8.50%**
Meet Capital Requirements?				
Tier 1 Capital	**Yes**	**Yes**	**No**	**Yes**

*Table courtesy of Risk Management Association

As is demonstrated by this example, if a bank's tier 1 capital is computed under Basel I, it would produce a number that is below what the tier 1 capital would be if computed under Basel III. Thus, a bank could be in full compliance with Basel III but find itself in the curious position of being subject to the Basel III restrictions that apply when a bank's capital is below the minimum tier 1 requirement plus the "capital conservation buffer."[5]

The ABA is concerned that the proposal will significantly undermine the progress made in recent years towards a more risk-sensitive approach to capital allocation. Capital clearly is important to the strength of a financial institution. However, efforts to make an institution safer

[5] Under Basel III, the minimum tier 1 level would be 6.0 percent. However, banks also would have to hold an additional 2.5 percent in tier 1 capital as a capital conservation buffer. Thus, effectively the minimum tier 1 requirement will be 8.5 percent. A bank that holds less than 8.5 percent of tier 1 capital will find itself subject to restrictions on activities that could deplete capital, such as the payment of dividends or stock repurchases.

by requiring ever more capital can have the unintended effect of incenting a bank to take more risks in order to earn a return on equity sufficient to attract and retain capital.

Imposing a floor that is tied to Basel I rules raises the question of why any bank would want to undertake the expense and effort to convert to the advanced approaches rules if it has the option not to do so. Such rules become, in essence, very expensive risk management exercises if minimum capital levels will be determined by the less risk-sensitive Basel I rules. We recognize that Section 171 dictates that insured depository institutions and their holding companies must hold capital that is no less than the generally applicable risk-based capital rules. As those rules evolve, we urge the U.S. regulators to avoid rulemakings that would place U.S. institutions at a competitive disadvantage vis-à-vis their foreign competition.

Below are the questions posed in the proposal and our responses.

Question 1: How should the new proposed rule be applied to foreign banks in evaluating capital equivalency in the context of applications to establish branches or make bank or nonbank acquisitions in the United States, and in evaluating capital comparability in the context of foreign bank FHC declarations?

Response: Section 171 states clearly that a "depository institution holding company" includes any U.S. bank or savings and loan holding company that is controlled by a foreign organization but does not include the foreign organization itself. Thus, the capital floor proposal would apply to the U.S. BHC or S&LHC and its depository institution subsidiaries. These institutions would be subject to the same calculations of minimum capital under both the "generally applicable risk-based capital requirements" and, as applicable, the advanced approaches. We support the application of comparable capital standards applied to the U.S. operations of foreign institutions.

The remaining question is whether Section 171 should apply to the foreign institution itself when the Board is reviewing an application by a foreign bank to establish a branch or agency in the U.S., to make a bank or nonbank acquisition, or to make a declaration to be treated as a financial holding company under the Bank Holding Company Act. A literal reading of Section 171 suggests that this falls outside the scope of the statute. This interpretation is supported by statements made when Section 171 was being considered by the Senate.[6]

A broader reading of Section 171 that imposed higher capital requirements on not only foreign-controlled entities operating in the U.S. but also on the foreign entities themselves would indirectly extend the reach of the U.S. capital rules in ways that could be detrimental to the interests of U.S. institutions operating internationally. Given the explicit carve-out of foreign organizations in the statute, we recommend that the U.S. regulators apply Section 171 in a manner that focuses on ensuring comparable capital requirements for all institutions operating within the U.S.

Question 2: The agencies seek comment generally on the impact of a permanent floor on the minimum risk-based capital requirements for banking organizations subject to the advanced

[6] *See* letter dated May 21, 2010, from FDIC Chairman Sheila Bair to Lawrence R. Uhlick, Institute of International Bankers, at 1.

approaches rule, and on the manner in which the agencies are proposing to implement the provisions of section 171(b) of the Act.

Response: As discussed above, we are concerned that the proposal goes beyond what is required by Section 171 of the Dodd-Frank Act and could place a bank in the presumably unintended situation of being fully compliant with Basel III and yet subject to restrictions imposed on banks that are not. We recognize that the statute imposes a floor tied to the minimum capital required under Basel I. However, this does not mean that a bank's compliance with the minimum levels required by Basel III should be computed by applying Basel I rules. Simply put, advanced approaches banks should meet Basel I requirements using a Basel I framework and meet Basel III requirements using a Basel III framework.

The capital floors under Section 171 will represent a significant step backwards from the progress that has been made towards more reliable risk-sensitive capital allocations. Imposing a binding constraint that is based on the generally applicable capital rules in the excessively conservative version found in the proposal calls into question the utility of the advanced approaches, particularly given the extraordinary time, effort, and cost of implementing these approaches. While we understand that the regulators must adopt rules implementing Section 171, we urge them to do so in a manner that builds on the gains made in recent years in risk modeling where possible.

One step in that direction would be to clarify in the final rule what the agencies' expectations are for banks that are in the process of phasing in Basel II. That process necessarily involves an enormous amount of work, as the agencies recognized when Basel II was adopted in the U.S. The timeline for phasing in the advanced approaches should not be expedited, lest the agencies pile even more burden onto banks and their holding companies along with the avalanche of burdens already hitting these institutions.

The proposal would resolve one question that arises from Section 171's requirement that the minimum capital standards be no less than the minimum requirements that apply under the Prompt Corrective Action (PCA) rules. Under those rules, a bank will be deemed to fall into one of 5 capital categories, 4 of which use more than one measure of capital.[7] Thus, it is impossible to know what the minimum capital requirement is under Section 171 without further clarification by the agencies. The proposal resolves this by requiring covered institutions to comply with the existing regulatory minimums of at least 8 percent for total risk-based capital and 4 percent for tier 1 risk-based capital. We believe this is an appropriate implementation of the statute.

Another issue that arises under Section 171 concerns whether the statute requires institutions that are subject to the advanced approaches rules to compute capital under the Basel I rules as they existed as of the date of enactment of the Dodd-Frank Act (*i.e.*, July 21, 2010) in addition to capital under Basel I as it gets amended. The preamble discussion resolves this issue by stating that the "agencies would not anticipate proposing to require banking organizations to compute two sets of generally applicable capital requirements from current and historic

[7] For instance, to be considered "well capitalized" under the PCA a bank must have total capital equal to at least 10 percent of risk-weighted assets, tier 1 capital equal to at least 6 percent of risk-weighted assets, and a leverage ratio equal to at least 5 percent. To be considered "adequately capitalized,' a bank must hold total risk-based capital of at least 8 percent, tier 1 capital of at least 4 percent, and a leverage ratio of at least 4 percent (or 3 percent if the bank has a composite rating of 1 under the CAMELS rating).

frameworks….”[8] Thus, an institution subject to the advanced approaches will have to make two sets of computations – one under the advanced approaches rules and one under Basel I as amended – but it will not have to make a third computation of capital under the Basel I rules as they existed on July 21 of last year. We think this is a sensible approach if two computations must continue to be made going forward.[9]

Question 3: For what specific types of exposures do commenters believe [the low-risk asset] treatment is appropriate? Does the proposal provide sufficient flexibility to address the exposures of depository institution holding companies and nonbank financial companies supervised by the Federal Reserve? If not, how should the proposal be changed to recognize the considerations outlined in this section?

Response: We agree with the general principle of aligning capital requirements with the relative risk of an asset. Thus, we support an approach that relies less on an automatic default assignment of an asset to the 100 percent risk category and more on an assignment to a risk category that better reflects the actual risk arising from the asset.

An example of an asset for which the proposed flexibility would be appropriate is the unconsolidated "separate account" asset reported by insurance companies. Typically, separate account assets are considered to be no risk to the insurer as the entire investment risk is passed on to the accountholder. The risk-based capital charge should be commensurate with the risk. Moreover, for the separate account assets that have guarantees embedded in such products, we suggest that the agencies apply a "look-through" approach whereby the underlying assets of such accounts are risk-weighted based on the type of assets.

One of the requirements for use of the low-risk asset treatment is that the bank is not authorized to hold the asset under applicable law other than debt previously contracted or similar authority. Assignment to a risk category should be based on the risk of the asset and not on the underlying authority to own the asset. Accordingly, we suggest the requirement that the asset be held subject to DPC or similar authority be removed from the rule.

Question 4: The agencies request comment on the most appropriate method of conducting the [quantitative analysis of the likely effect on capital requirements as part of developing future amendments to the capital rules to ensure that any new capital framework is not quantitatively lower than the requirements in effect as of the date of enactment of DFA], including potential quantitative methods for comparing future capital requirements to ensure that any new capital framework is not quantitatively lower than the requirements in effect as of the date of enactment of DFA.

Response: The final rule should address how the agencies will determine whether a proposed change to Basel I would result in a “quantitatively lower” capital requirement. The proposal states that the agencies will not amend Basel I until after they have made a

[8] 75 Fed. Reg. at 82320.

[9] We note that the proposal’s elimination of section 21(e) from the various appendices in which the advanced approaches rules are codified needs to be reflected elsewhere in that section. For instance, paragraphs (a) and (d) of section 21 refer to floor periods, which will not exist once section 21(e) is eliminated. Conforming amendments thus will be required. Moreover, the proposed elimination of section 21(e) will make guidance on a bank’s transition to Basel III (once Basel III is adopted in the U.S.) all the more important.

determination that the proposed amendment would not result in "quantitatively lower" capital requirements. The question arises whether the agencies will measure this on the basis of asset class, whole bank, or industry-wide.

The more granular the level that is used to make this determination, the higher the cumulative capital requirements will be. For instance, if the agencies compare proposed changes asset by asset, any change always would result in higher minimum capital requirements as the capital charge for the asset in question goes up while capital charges for all other assets stay the same. This would be an unnecessary and counterproductive outcome, because it would result in a bank holding an aggregate amount of capital that exceeds its overall risk profile.

If, by contrast, the determination were to focus on whether the aggregate amount of capital industry-wide would increase or decrease as a result of a proposed change to Basel I, any individual bank would still be free to adjust its business model to find the optimal combination of risk tolerance and risk mitigation for that bank. Levels of required capital would continue to be linked to a bank's risk profile, and the regulators could avoid the unintended consequence noted above of incenting a bank to take more risk to earn a sufficient return on the additional required capital.

Question 5: The agencies seek comment on all other aspects of this proposed rule, including the costs and benefits. What, if any, changes should the agencies make to the proposed rule or the risk-based capital framework to better balance costs and benefits?

Response: As previously discussed, we are very concerned about the costs imposed of forcing advanced approaches banks to maintain the dual systems needed to determine compliance with Basel I and advanced approaches rules. Capital adequacy clearly is a vital component to the health of any individual institution and to our banking system as a whole. However, over-reliance on capital can create inefficient use of capital by individual banks and taken altogether a concomitant reduction in the efficient use of capital within the economy. That would have undeniably negative consequences for the competitiveness of the U.S. financial industry and for economic growth for the U.S. economy overall. The agencies must remain mindful of the cumulative burden of this rule and the many others that have been, or soon will be, adopted.

Thank you for considering our views. If you would like to discuss any of the points raised in our letter, please feel free to contact the undersigned at your convenience.

Sincerely,

Mark J. Tenhundfeld
Senior Vice President