THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy

1001 PENNSYLVANIA AVE., NW
SUITE 500 SOUTH
WASHINGTON, DC 20004
TEL 202-289-4322
FAX 202-628-2507

E-Mail rich@fsround.org
www.fsround.org

RICHARD M. WHITING
EXECUTIVE DIRECTOR
AND GENERAL COUNSEL

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Office of the Comptroller of the Currency
250 E Street, SW, Mail Stop 2-3
Washington, D.C. 20219

Jennifer J. Johnson, Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Robert E. Feldman, Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Joint Notice of Proposed Rulemaking for Establishment of a Risk-based Capital Floor

Dear Sirs and Mesdames:

The Financial Services Roundtable ("Roundtable") is writing to comment on the above-referenced notice promulgated by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System (the "Board"), and the Federal Deposit Insurance Corporation (collectively the "Agencies") and appreciates the opportunity to do so. The Roundtable is a national trade association of 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to American consumers and businesses. Roundtable member companies account directly for $74.7 trillion in managed assets, $1.1 trillion in revenue, and 2.3 million jobs.

<u>Procedural Issue</u>

The proposed rule would amend current Basel II capital rules (1) to comply with the Dodd-Frank Act that requires large banks to capitalize at least at the level required by the current generally applicable risk-based capital rule and also (2) to provide flexibility for recognizing the relative risk of certain assets generally not held by depository institutions, but that may be held by nonbank financial firms that may be designated as systemically significant by the Financial Stability Oversight Council (the "FSOC" or the "Council"). At this time, the Council has not designated any such firms and, indeed, is currently considering public comment on regulations it has proposed that would govern the process the Council would use to designate a firm as systemically significant.

Thus, other than banking organizations, the firms that may be subject to the above-referenced proposed rulemaking do not know who they are or that they would be subject to the rule being proposed. In discussing the proposal with our members, it became apparent that it is conceivable that some might someday be designated systemically significant by the Council and, thus, might be affected by the proposal, but, at this time, it is unclear which ones they might be, and that has handicapped somewhat the ability of all potentially affected parties to provide comments on the proposal.

Policy Issue with Section 171

We recognize that the first half of the proposal, i.e. establishing a Basel I-based floor on capital irrespective of Basel II, merely implements Section 171 of the Dodd-Frank Act. Section 171, of course, is the so-called "Collins Amendment", which garnered considerable attention as the bill that became the Act moved through Congress. Much of that attention had to do with that aspect of the Amendment concerning the treatment of trust preferred stock as capital. That portion of the Amendment that is the basis of the current proposal received less public and media attention. Consequently, Congress' intent in establishing a Basel I-based floor on capital is not manifestly clear.

The core issue in the Notice of Proposed Rulemaking is the impact the recent financial crisis has had on confidence in any quantitative model's ability to measure risk effectively. While recognizing the challenge that the past several years has presented on this issue, the Roundtable strongly suggests that the Agencies act with caution on this issue. The primary purpose of the world-wide effort to implement the Basel II approach to estimating risk-weighted assets has been to increase the risk-sensitivity of regulatory capital measures. The Roundtable believes that this remains a worthwhile goal.

One goal of the Basel II system was to create a process for estimating risk-weighted assets that was "capital neutral"; that is, the new process would not have any material impact on the aggregate need for capital in the banking system. While some institutions would hold less capital (if the risk-rating models approved by their supervisors showed them to be of lower risk), this would be balanced by additional capital from the institutions having to hold more capital. Many money center banks, irrespective of the proposed rule, may be expected, as a consequence of Basel II, the pending market risk capital rule changes, and Basel III, to be required to hold more capital. However, many banking organizations that would utilize Basel II have lower risk profiles and, but for the proposed rule, would have lower capital requirements. The proposed rule would result in no risk-sensitivity in the lowest-risk sector of the industry (with risk as measured by internal models). This would provide a strong disincentive for such institutions to hold less than industry-average levels of risk; presuming that risk and return are positively correlated, such firms would hold more risk to generate sufficient returns on the disproportionately higher capital they are required to hold to satisfy the Basel I floor as required by the proposed rule. The consequence of this could well be a higher average level of risk in the industry than would have occurred under the Basel II implementation. Banking organizations that would have lower capital requirements under Basel II because they undertake less risk by avoiding trading activity and lending to highly-rated borrowers, should be rewarded, not penalized.

Requiring less risky organizations to hold more capital than risk requires would have subtle, but seriously adverse, implications for markets. Organizations required to maintain higher capital than risk requires will have to recover the cost of unnecessary capital by charging borrowers and other customers more than they otherwise would charge and by paying depositors lower amounts of interest. Such firms also would have to compete in capital markets for capital unnecessarily driving up costs of capital for those firms that truly need to raise capital to cover real risk.

Larger banks with trading portfolios would also experience adverse effects from the proposal. Their capital levels might not be affected by the proposed Basel I floor as their capital levels are likely to increase substantially above those floors as Basel II, the market risk proposal, and Basel III are implemented. However, under the proposal, to ensure compliance with the required Basel I capital floors, these larger banks would be required to maintain systems and software to measure the amount of capital required under Basel I even though their capital levels are sure to exceed Basel I capital requirements. That not insignificant expense will constitute not only a burden, but an absolutely unnecessary burden, essentially a waste of resources because undoubtedly the capital levels of such banking organizations invariably will exceed the Basel I floors. Perhaps the Agencies might consider an exemption from any requirement to calculate capital under Basel I where the risk-weighted assets of a firm's trading book under Basel II exceeds a certain percentage of the firm's total risk-weighted assets. We suspect that many large banks would be willing to work with the Agencies to help identify an appropriate percentage for the triggering of such an exemption.

That portion of Section 171 that is the basis of the instant proposal is essentially a rejection of the Basel II advanced approach. Basel II's advanced approach was based on an extraordinary amount of work by banking supervisory authorities around the world and was very carefully studied by the Agencies before it was adopted in the U.S. in 2007. American banks affected by Basel II have spent hundreds of millions of dollars in state-of-the art systems improvements to be able to use more granular sophisticated measurements of risk presumably to justify lower capital ratios. Section 171 and the instant proposal would eliminate the capital cost savings for which those hundreds of millions of dollars were invested and would re-impose on the banks that have developed sophisticated risk measurement models the cruder simplistic Basel I capital system adopted in 1989 in the U.S., discarding years of hard work and expense.

To the extent that the proposed capital floors would be imposed on nonbank financial firms that some day are designated by the Council as systemically significant, an obvious competitive handicap would be imposed on such firms. They would be required to maintain higher levels of costly capital than their non-systemically significant competitors maintain, driving up the costs of the former and the prices the former must charge, which is sure to reduce their market shares eventually.

We recognize that, under Section 171, the bank regulators had the option of imposing an even higher floor than Basel I, but resisted doing so, and we commend the agencies for that.

<u>Specific Questions</u>

The agencies have expressly asked how the new rule should be applied to foreign banks doing business in the U. S.:

> "<u>Question #1:</u> *How should the 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 the capital comparability in the context of foreign bank FHC declarations?"

The Roundtable supports the current approach of ensuring that there are, as is stated in the Notice, "comparable capital and management standards" applied to foreign institutions in the United States as compared to domestic (US) banks.

That said, our members strongly feel that it would be highly improper to impose a Basel I capital floor on non-U. S. operations of foreign banks. It is one thing to strive for competitive equality within the U. S. However, U. S. bank regulators should defer to home country supervision and capital requirements for foreign banks' non-U. S. activities. This is suggested not only by fundamental concepts of fairness, but also out of concern that imposing a Basel I capital floor extraterritorially might well trigger retaliation by foreign bank supervisors against U. S. bank operations abroad.

"<u>Question 2:</u> *The Regulatory 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 approaches rules, and on the manner in which the agencies are proposing to implement the provisions of section 171(b) of the Act."*

As mentioned above, the Roundtable is concerned that the approach outlined in the Notice will have the unintended consequence of increasing the aggregate risk level in the industry, certainly among Basel II banks that do not engage in active trading or greater risk-taking. The last several years have taught the industry and agencies a great deal about systemic risk and pointed out flaws in the models used by all participants. However, this does not mean that the field of quantitative risk management cannot be useful in understanding a bank's risk profile. To give a simple example, if there are two banks with mortgage portfolios equal in all ways except the distribution of obligors, one bank lending only to obligors with FICO scores above 700 and the other to obligors with FICO scores below 640, a strong opinion about the capital requirements can be reasonably modeled and made. Eliminating risk sensitivity for a significant portion of the industry is too high a price to pay to address model error, and imposing unnecessary systems expense on the rest of the industry, i.e. banks whose capital levels certainly would be required by other capital requirements to exceed the Basel I floors, is inefficient and wasteful.

<u>Imposing Capital Requirements on Systemically Important Financial Institutions</u>

"<u>Question 3:</u> *For what specific types of exposure do commenters believe this 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?"*

This aspect of the proposal particularly affects systemically significant nonbank financial firms that may de determined by the FSOC to be in need of enhanced prudential supervision by the Board. As mentioned above, the FSOC has yet to designate any such firms and, indeed, is only, at this time, in the process of adopting procedures on how such determinations will be made. Thus, how the assets of such firms should be risk-weighted appears to present more than the normal level of abstraction.

The Roundtable broadly agrees with the approach, with the understanding that the focus of the Proposed Rule will be to ensure no regulatory arbitrage. It is understood that this question will likely have to be asked again as both the industry and the Regulatory Agencies gain more experience and practical examples in this area.[

Some experts believe it is untenable to try to apply bank-like capital requirements to nonbank financial firms. The risks associated with many assets of such firms were not contemplated when Basel I was developed and thus these assets have not been assigned any specific risk weights. Under Basel I, an asset not explicitly assigned a lower risk weight carries a 100 percent risk weight which could overstate exposure. The agencies propose that such an asset may be assigned a different risk weight category "if the risks associated with the asset are substantially similar to the risks of assets that are otherwise assigned to a risk weight category of less than 100 percent". While that seems fine in principle, its application seems quite vague. How does one assess the risks associated with a non-bankable asset? How does one even identify those risks? What are the risks of assets assigned to each of the non-100 percent risk weight categories? Clarification would be helpful.

Special Considerations Applicable to Insurance Companies

Complicating this even more is the fact that some financial firms, such as insurance companies, hold financial assets that present risks quite dissimilar to the risks associated with financial assets held by depository organizations. Insurance companies hold debt instruments that have a different character and a different maturity than those held by depository organizations. In the case of variable life and annuity contracts, insurance companies also hold, on their balance sheets, substantial amounts of assets that expose the companies to no investment risk whatsoever because the investment risk is borne by policyholders. The different risk exposures of insurance company balance sheets also should be considered in the context of the liability structure of such firms which is much different and, in some ways, more stable than that of depository organizations whose liabilities may consist significantly of demand deposits and even brokered CDs and other forms of "hot money". Applying bank capital requirements to insurance companies without taking those differences into account is overly simplistic and may lead to distorted incentives, unuseful metrics for the Agencies and competitive imbalances.

One possible alternative would be to follow the long-standing precedent the Board has established in the area of foreign bank capital equivalence; the analogy here would be for the Agencies to defer to the expertise of insurance regulators. State insurance regulators impose risk-based capital requirements on insurance companies. It is not clear why bank regulators should disregard the existing insurance risk based capital system even if the insurance company owns a depository institution or is systemically significant.

Also, we are aware of several instances in which very large insurance companies own relatively small depository institutions and thus are depository institution holding companies. For instance, a $140 billion insurance company might own a $4 billion depository institution. In such cases, insurance risks and exposures dominate the balance sheets of such holding companies. For the Agencies to apply an ill-suited regulatory capital structure when an existing one is available is unwise and unnecessary. It also could curtail the insurance capacity of insurers, even potentially disrupting and destabilizing insurance markets.

In 2002, the Board and the National Association of Insurance Commissioners issued a joint report that found that differences between bank capital and insurance capital rules could not be harmonized simply by changing nominal capital charges on individual assets. This further supports the inadvisability of trying to apply bank-like capital rules to insurance companies.

Another particular insurance industry issue that has come to our attention arises from the fact that many insurance companies do not report their financial condition using Generally Accepted Accounting Principles ("GAAP"), but rather use Statutory Accounting Principles ("SAP"). It would create a substantial burden on any such company to be required to use GAAP, instead of SAP, to calculate its capital requirements as such an insurance company would then need to use two different accounting systems and possibly double its accounting costs. Insurance companies should be permitted to calculate capital requirements using SAP.

There exists substantial precedent for this as the Board graciously today permits foreign banking organizations doing business in the U. S. that do not use GAAP to continue with their use of non-GAAP accounting, and the Office of Thrift Supervision permits insurance companies that are thrift holding companies to file SAP-based financial reports. This issue was recognized in the Senate Banking Committee Report on the Dodd-Frank Act (the "Act") in which Section 616 of the Act, requiring regulation regarding capital levels, is discussed. The Report expressly states that regulatory accounting practices and procedures applicable to holding companies that are insurance companies should be taken into account and that Section 616, at least, is not intended to mandate that insurance companies subject to alternative regulatory accounting practices and policies use GAAP.

> <u>"Question 4:</u> *The Regulatory Agencies request comment on the most appropriate method of conducting the aforementioned analysis, 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 the enactment of the Act."*

The Roundtable strongly believes that banking organizations should not be required to compute two sets of generally applicable capital requirements from current and historical frameworks. This will require that any potential changes to the capital requirements must be fully tested by the agencies prior to implementation to ensure that these changes do not violate the Dodd-Frank Act. The member institutions of the Roundtable would strongly prefer working with the agencies in the testing process rather than being required to perform multiple sets of capital calculations.

In regards to the different potential approaches to testing the impact of possible changes to the capital framework to ensure that they do not materially lower capital requirements, the Roundtable believes there would be benefit to clarifying the goal. One possible interpretation of the issue is that no change could be made to the capital rules that would result in less capital being held in the industry, regardless of risk. The Roundtable believes that this goal would be extremely misguided. For example, consider an improvement to our current understanding of the relative riskiness of what is now viewed as a homogenous pool of assets. It is possible that, in the future, we could realize that such a pool really consists of two sub-pools, one very risky and one of minimal risk. It would be appropriate to increase the risk-weighting of the risky sub-pool, and lower that of the remainder, so that the average risk-weighting is the same. This approach could easily result in the industry reducing exposure to the risky sub-pool either by designing products that minimize the risk, or simply reducing exposure to it for the purpose of sound risk management The result could easily be reduced risk to the system and lower capital requirements. It is difficult to understand how this would not be a desirable outcome.

Another possible interpretation of the goal is that, given a stable risk profile in the industry, the amount of capital should not decrease. This view is less problematic than the previous interpretation. In many ways, this is a problem of data segmentation—data may be segmented in such a way as to allow for risk-weighting under the current set of rules, but not for a given proposed set of rules. This makes it extremely difficult to address the question of whether a proposed change in approach may, immediately or over time, lead to a reduction in capital requirements. Using a similar example to the previous paragraph, consider a pool of assets has a current risk weighting of 50% and is split into two sub pools with risk weightings of 40% and 60% respectively, with the assumption that the two sub-pools are of equal size (so there is no change in aggregate capital requirements). To be sure that this assumption is correct, it would need to be tested, using current and historical data, which may be extremely difficult. Banks may well not have tracked the data in a way to allow this segmentation, or the industry may not have consistent data definitions to allow for a meaningful test across the industry. No method will deal with this problem perfectly. Two suggestions seem obvious: either involve enough of the industry in this process to ensure that sufficient testing is done prior to any rule issuance (working with groups such as the Roundtable) or have this become part of the work program for the Office of Financial Research. The Roundtable believes that the best approach would be to work with the industry to understand best current and forecasted impacts of any potential rule changes. This will get a broad set of perspectives involved in the process, will ensure the best understanding of the data used (of critical importance in addressing the question of inconsistent data definitions), and will ensure buy-in upon completion.

Entirely apart from testing potential future changes to capital requirements to avoid requiring computation of two sets of capital requirements , we are very concerned about the wastefulness of the implicit requirement in the proposal that large banks with trading portfolios that will be subject to Basel II, market risk capital requirements, and Basel III, and would thereby be required to maintain higher capital requirements than Basel I, would be forced not only to compute capital under those higher requirements, but also to compute capital requirements under Basel I. That will require systems and personnel expense even though it would be clear, even before that expense is incurred, that the capital of such banks exceeds Basel I floors.

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

The proposed rule is a material change to the regulatory framework of the United States, and it will materially impact all large financial institutions based in this country. First, all Basel II-compliant financial institutions will have permanently higher operating costs, which will negatively impact their clients and their shareholders; will, on the margin, move business from the banking industry to less regulated areas; and will reduce the incentive for financial institutions that are under the mandatory size limit for Basel II to make the material investments necessary to become Basel II-compliant. Second, the largest banking organizations with active trading desks will be forced to incur totally unnecessary systems expenses to calculate capital under Basel I even though their capital requirements will surely exceed Basel I capital requirements.

The most beneficial change that could be made to the risk-based capital framework to balance costs and benefits better would be to reduce the cost of Basel II compliance. The Roundtable strongly supports the goal of better understanding an institution's risk profile as is achieved with Basel II. However, complying with Basel II is exceptionally expensive, in no small part due to the very low standards of materiality that are embedded in Basel II. Raising the materiality standard to exempt small, relatively low-risk portfolios from the Basel II risk-weighting process would allow financial institutions under Basel II to focus their time and resources on the portfolios with the greatest contributions to their risk profile, improving the risk management of the institutions. The savings in time and money would be material, and the cost in terms of lessened risk sensitivity would be minor. This would particularly be the case if the proposed rule becomes effective, as Basel II banks will have Basel I-based capital ratios as a floor.

Conclusion

The Roundtable appreciates the opportunity to participate in the discussion surrounding this Notice of Proposed Rulemaking. The Roundtable recognizes that the agencies are trying to balance two contradictory goals: keeping the risk sensitivity captured by Basel II and having a hard, non-model- driven floor to capital levels. The work as seen in this Notice is a strong attempt to balance these two objectives. However, the Roundtable believes that there would be benefit to reconsidering the simple approach taken to maintaining current capital minimums. A clear statement of the goals of this Notice would be beneficial. In particular, to what extent is the goal of the Notice to ensure that, given the current risk profile of the industry, no new capital rules will result in a decrease in capital ratios, and to what extent is the goal to ensure that, regardless of the risk profile of the industry, capital ratios stay at or above current levels? The implications of this choice are significant. The Roundtable is concerned that, if the second goal is the real goal, it will create distorted incentives for financial services institutions, encouraging additional risk-taking to cover the costs associated with the holding of high levels of capital.

Thank you for this opportunity to express our views.

Best wishes,

Richard M. Whiting

Richard M. Whiting
Executive Director