

October 24, 2012

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

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

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

Re: Basel III Capital Proposals

Ladies and Gentlemen:

Thank you for the opportunity to provide comments on the Basel III proposals that were recently released by the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation in their June 7, 2012 joint Notice of Proposed Rulemaking (NPR).

Webster Financial Corporation is a bank holding company. Its subsidiary, Webster Bank, N.A., is a \$20 billion regional full-service consumer and commercial community bank headquartered in Connecticut and founded in the Great Depression to help people buy and build their homes. Webster Bank, N.A., has 167 branches stretching from Boston to Westchester County, NY. Webster Financial Corporation and Webster Bank, N.A. (individually and/or collectively, "Webster") are major providers of banking products and banking related services to middle market companies, small businesses and families in our region. In our 77 years, we have had two CEOs – our founder, Harold Webster Smith, and his son, Jim Smith, who has held that title since 1987. Throughout our history and growth, we have never lost sight of whom we serve and why we exist, something we call The Webster Way.

Webster's philosophy of banking was best illustrated during the residential mortgage crisis. Since 2008, Webster has modified the payment terms of mortgages with balances totaling in the aggregate more than \$200 million. These modifications have saved homeowners an average of more than \$300 a month and kept more than 1,200 families in their homes. In that time, Webster has not had a single adversarial mortgage foreclosure where we were able to contact the borrower. What distinguishes Webster is that we have addressed head-on the issue of affordability for borrowers who have encountered difficulties through no fault of their own; we have not just postponed the day of reckoning. As a result of Webster's proactive approach our

re-default rate on modified mortgages is approximately 13 percent, less than a third of the industry average. Our mortgage modification program was profiled in The Wall Street Journal, and The Hartford Courant and also on ABC News in 2011.

We highlight our history to illustrate the importance Webster has attached to serving its communities by being a responsible lender. The proposed change in capital requirement and risk weightings is of great concern to us and we appreciate the opportunity to comment on the proposal. We are concerned the proposed changes would make it difficult to continue to serve our customers and communities effectively. We also believe that the changes will reduce our capacity to lend and that they will increase systemic risk for the industry as a whole.

We are focusing our comments on the questions related to unrealized gains and losses on all debt securities being included as part of capital. We share many of the same concerns that the industry has raised in regard to proposed changes in risk weightings and have participated in various group response letters.

Below are our detailed responses with our own perspective to questions raised in the NPR:

### **Basel III NPR Questions**

**Question 15:** To what extent would a requirement to include unrealized gains and losses on all debt securities whose changes in fair value are recognized in AOCI (i) result in excessive volatility in regulatory capital; (ii) impact the levels of liquid assets held by banking organizations; (iii) affect the composition of the banking organization's securities portfolios; and (iv) pose challenges for banking organizations' asset-liability management? Please provide supporting data and analysis.

Webster, like most banks, relies on its investment portfolio to manage its interest rate risk and to provide liquidity. Our core deposits generally have longer durations than our loans and the amount of deposits exceeds that of loans by approximately \$2.5 billion. Our naturally "asset sensitive" balance sheet creates both interest rate risk (IRR) and excess liquidity. In order to manage IRR, we invest in securities with durations that typically range from 3 to 6 years. This enables us to minimize the volatility of both the net economic value and the net interest income of the Bank over time regardless of the future path of interest rates.

Approximately half of our \$6.2 billion investment portfolio is in the Available For Sale classification in order to better manage liquidity and maintain balance sheet flexibility. This classification puts \$3.1 billion of securities or approximately 16 percent of our balance sheet at risk of changing market values that would flow into our regulatory capital ratios under the NPR.

We estimate that a 200 basis point parallel rise in interest rates would have reduced our regulatory Tier 1 common capital by approximately \$85 million or 65 basis points as of September 30. As previously highlighted, our balance sheet structure has been designed such that we are essentially indifferent to changes in interest rates. Based on our modeling estimates, the net economic value of the Bank would actually increase by over 4 percent while our earnings over the next year would essentially be unaffected by this 200 basis point rate movement.

Unfortunately, our regulatory capital position would be negatively impacted despite the economic and accounting value of the Bank remaining essentially unchanged. We would expect to see similar results across the industry as most banks try to avoid significant interest rate risk and use their investment portfolios in the same manner as Webster.

The path of interest rates has been in a downward cycle for the last 30 years. Rates will inevitably change direction in the future. Since we are starting from historically low levels, any rise to a normal environment could be dramatic. Long term rates were 500 basis points higher just 5 years ago. Many of us worked in banking during an era of the Prime rate exceeding 10 percent and some of us recall a time when the Prime rate exceeded 20 percent. With no easy way to hedge that potentially extreme regulatory capital risk, banks like Webster would have to fundamentally change the way we manage our balance sheet.

Alternatives for managing this new risk would be costly and/or create additional risks of their own.

Actions we and the industry may be forced to contemplate include:

- a. **Move investments into Held To Maturity** – This would enable us to maintain the duration we need for IRR management but at a cost of increased liquidity risk and reduced balance sheet flexibility.
- b. **Shorten investment durations** – This would reduce the regulatory capital volatility but increase net economic value volatility, increase longer term earnings volatility and reduce the level of current and long term earnings. The reduction in earnings would ultimately lead to lower retained earnings and therefore lower organic capital generation capability.
- c. **Shrink the investment portfolio** – This would have much the same effect as shortening investment durations since excess liquidity would likely be held as cash instead of investments. Currently our AFS portfolio yields approximately 2.85 percent. Replacing this with cash earning 0.25 percent would reduce the Bank's pre-tax earnings by approximately \$75 million for a year. That represents approximately one third of the Bank's 2011 earnings and capital generating ability.
- d. **Shrink the loan portfolio when rates rise** – Since regulatory capital would decline as rates rise, the balance sheet would not be able to accommodate as many high risk weighted assets, i.e., loans. For example a 200 basis point rise would cause Webster to lose the capacity to hold over \$1 billion of consumer, commercial and small business loans, or the equivalent of almost 10 percent of our total loan portfolio today. This would result in a reduction in the loans we could otherwise make to support the communities we serve.
- e. **Hold more capital** – Alternatively we and other banks could guard against this risk by carrying additional capital. This excess capital, however, would be held in reserve and would not be available for lending.



In addition to the above, we would expect development of new on and off balance sheet products designed to protect the banking industry from this new regulatory risk. These new products would likely be an added economic cost to banks for a non-economic risk that does not exist today. We believe such a development would also create new systemic counterparty risks.

The lower earnings resulting from any of these actions combined with higher capital requirements will also reduce expected returns for banks and potentially reduce the pool of capital willing to invest in banks.

On a fundamental basis, we respectfully disagree with the logic of including valuation changes from one part of the balance sheet into regulatory capital when that part (investments) typically represents a hedge of another part (deposits) that is not marked through capital. One argument we have heard supporting the change is that banks might have to sell those underwater securities when times are tough and capital is low and therefore unrealized losses should count against regulatory capital to be prudent. Most banks buy securities with the intent and ability to hold to maturity. When sales do take place, however, we think banks are more likely to record gains to offset credit losses during recessions rather than take losses when rates are rising and the economy is strong.

We think such a change in regulatory capital calculations will do more harm than good and will create unintended consequences. While it may make conceptual sense to include the credit risk component of market value changes into capital, we think current accounting rules already provide a mechanism for that to happen. Other than temporary impairment (OTTI) is already typically recognized through earnings on credit sensitive investments and therefore in regulatory capital.

We recognize the market was concerned with the Tangible Common Equity (TCE) ratio during the crisis and that ratio includes unrealized gains and losses on Available for Sale investments. We think the market's concern, however, had more to do with potential credit losses related to loans than investments. OTTI was recognized in capital for most banks and that even after OTTI was recognized, more banks had gains rather than losses during the crisis due to the impact of lower interest rates on fixed rate non-credit sensitive portfolios.

A review of the top 50 banks using the SNL database (Exhibit A) reveals that after tax unrealized and realized gains and losses amounted to a small fraction of loan loss provisions and net charge-offs over the last five years. We would note that the \$38 billion of unrealized after tax losses at the end of 2008 must have been due primarily to credit spread widening since the 5 year swap rate fell 200 basis points that year. One year later in 2009, that loss was significantly reduced to less than \$8 billion despite a rise in interest rates during 2009. Most of those losses were either never realized due to subsequent credit spread tightening or were offset by realized gains due to interest rate changes compared to 2007. One year later in 2010, that small loss turned into a gain of \$5 billion that continued to grow to over \$16 billion in 2011 as interest rates fell again with additional gains realized through the P&L in both years. These relatively small losses in investment portfolios occurred faster than recognition of loan loss as evidenced by both provision and charge-offs still remaining in 2011 at three times the level of 2007.

Changing the regulatory capital rules would have weakened bank capital positions early during the crisis but strengthened capital as the crisis progressed. Banks raised most of their capital in 2009 and 2010 during the time when unrealized gains were increasing. The proposed rules may have actually lessened the need to raise additional capital from a regulatory perspective which seems counter to good public policy. Conversely, when the economy recovers and rates rise, an increase in unrealized losses may cause all banks (at the same time) to shrink their balance sheets or raise additional capital beyond that needed to cover credit risk or loan growth. Some of the larger banks may also have to hold a counter cyclical buffer during the boom times further increasing the amount of capital they and the entire system would have to raise. We are concerned that banks may not be able to find sufficient sources of capital if we all have to raise capital at the same time and with a diminished ability to deploy it profitably.

**Question 16:** What are the pros and cons of an alternative treatment that would allow U.S. banking organizations to exclude from regulatory capital unrealized gains and losses on debt securities whose changes in fair value are predominantly attributable to fluctuations in a benchmark interest rate (for example, U.S. government and agency debt obligations and U.S. GSE debt obligations)? In the context of such an alternative treatment, what other categories of securities should be considered and why? Are there other alternatives that the agencies should consider (for example, retaining the current treatment for unrealized gains and losses on AFS debt and equity securities)?

The alternative treatment suggested in the NPR is not broad enough. Even fixed rate credit sensitive investments will change in value along with interest rates. Those credit sensitive investments also act as hedges against IRR for most banks so those changes in market value should also be excluded at least to some degree. Our own bank, for example, has a \$500 million portfolio of mostly AAA rated and 20 percent risk weighted Commercial Mortgage Backed Securities with a duration of over 4 years that we use as a hedge of IRR. Most of these securities will continue to qualify for a 20 percent risk weighted under the new Simplified Supervisory Formula Approach (SSFA). We owned much of this portfolio through the Great Recession and have not incurred any losses to date.

An alternative treatment would be to exclude any investment security held in AFS with a 50 percent or less risk weighting under the Standardized Approach. Although relatively simplistic, this approach would recognize that a significant portion of changes in market value are more likely to be due to changes in interest rates rather than changes in credit risk. We think this could cover the vast majority of most bank investment portfolios while still capturing most of the credit risk contained in bank portfolios.

Our preferred solution, however, would be to retain the current treatment for unrealized gains and losses on AFS debt and equity securities. This approach has the advantage of easing ever increasing reporting burdens and it has stood the test of time. We are unaware of any banks that failed due to losses in the investment portfolio that were hidden from the markets or the regulators due to their treatment in regulatory capital ratios. Strong regulatory oversight should be just as effective as a rule based approach without the disadvantage of creating regulatory capital volatility that is divorced from economics and prudent bank risk management.

**Question 28:** How would a requirement to exclude unrealized net gains and losses on cash flow hedges related to the hedging of items that are not measured at fair value in the balance sheet (in the context of a framework where the unrealized gains and losses on AFS debt securities would flow through to regulatory capital) change the way banking organizations currently hedge against interest rate risk? Please explain and provide supporting data and analysis.

Webster has periodically used cash flow hedges in modest amounts to manage IRR by converting existing floating rate liabilities to fixed rate or locking in rates on future debt issuances as a macro hedge against rising interest rates. These transactions are not meant to directly hedge the cash flow characteristics of investments or borrowings as the NPR seems to suggest. Banks are generally not in the business of making investments, borrowings and derivatives as a line of business. Instead, investments, borrowings and derivatives are all used to manage the IRR and liquidity risks created from the basic banking business - making loans and taking deposits. As long as loans and deposits are carried at historical cost, unnecessary and inappropriate capital volatility will be created by including unrealized gains or losses on just a portion of the balance sheet (or off balance sheet) in regulatory capital.

Current Generally Accepted Accounting Principles (GAAP) has the same issue in the calculation of TCE where unrealized gains and losses on AFS investments are included in the TCE calculation. GAAP, however, also permits the same treatment for cash flow hedges. Some banks use this treatment to reduce the volatility to TCE from changing interest rates. That flexibility would be lost if the rules are implemented as proposed in regulatory capital. We also believe the market would not solely use a declining TCE ratio to assess the capital position of banks in a rising rate environment.

A requirement to exclude the unrealized net gains and losses is likely to lead banks to make less use of cash flow hedges. The impacts may not be significant for a bank like Webster but could lead to actions similar to those listed in Question 15 for other banks to a larger degree.

**Question 29:** Could this adjustment potentially introduce excessive volatility in regulatory capital predominantly as a result of fluctuations in a benchmark interest rate for institutions that are effectively hedged against interest rate risk? Please explain and provide supporting data and analysis.

Yes. Any accounting system that does not completely reflect the business model of the industry will lead to undesirable volatility and distortions. The banking business model is primarily hold to maturity. AFS and HTM investments and cash flow hedges of liabilities are all used to manage IRR created by the rest of the balance sheet. Carrying only a portion of a balance sheet at market values and running those changes through capital as interest rates change will inevitably lead to capital volatility. These instruments all use duration to balance risk. That duration would create new risk to capital. The only way to reduce that capital risk is to reduce the duration of those instruments. Reducing the duration of those instruments defeats the purpose of having them in the first place and leaves the original economic risk of the balance sheet un-hedged in the desire to eliminate regulatory capital volatility.

I appreciate the opportunity to comment on these important questions and look forward to a decision on the final rules that, we are hopeful, incorporates the concerns we share with the industry. Thank you.

Sincerely,

A handwritten signature in blue ink, appearing to read "Glenn I. MacInnes", with a stylized, flowing script.

Glenn I. MacInnes  
EVP and Chief Financial Officer  
Webster Financial Corporation

## Exhibit A

Top 50 Banks

(\$ in billions)

	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
After tax Gain/(Loss)	\$ (3.9)	\$ (38.4)	\$ (7.5)	\$ 5.0	\$ 16.5
As % of Equity	0.6%	5.4%	0.9%	0.5%	1.6%
G/(L) on Sale of Securities	\$ 0.7	\$ (2.2)	\$ (1.3)	\$ 6.6	\$ 4.0
Provision	\$ 33.5	\$ 97.5	\$ 153.1	\$ 86.7	\$ 87.0
Charge-offs	\$ 27.0	\$ 60.0	\$ 121.9	\$ 120.6	\$ 73.1
Assets	\$ 7,071.4	\$ 8,156.0	\$ 8,175.7	\$ 8,844.2	\$ 9,578.5
Equity	\$ 663.6	\$ 709.6	\$ 862.1	\$ 970.9	\$ 1,046.1
5 Year Swap	4.18%	2.13%	2.98%	2.17%	1.22%

Source: SNL