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October 22, 2012

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

Thomas J. Curry
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

Dear Ms. Johnson, Mr. Curry, and Mr. Feldman:

Thank you for the opportunity to provide comment on the Basel III proposals[1] that were recently approved by the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (Agencies). Preparing the proposals was clearly a substantial undertaking and must have required significant, coordinated effort on the part of the Agencies.

BB&T[2] participates in a number of banking industry trade associations and is actively contributing to the comment-making process through them. Many of our positions are consistent with what is presented by the American Bankers Association, The Clearing House, and a number of financial institution peers. However, each institution's situation and perspective is unique and we feel a responsibility to comment on our own behalf in cases where a point requires emphasis due to its significance or where we believe we have something different to contribute.

[1] The proposals are titled: *Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, and Transition Provisions*; *Regulatory Capital Rules: Standardized Approach for Risk-weighted Assets; Market Discipline and Disclosure Requirements; and Regulatory Capital Rules: Advanced Approaches Risk-based Capital Rules; Market Risk Capital Rule.*

[2] As of September 30, 2012, BB&T is one of the largest financial services holding companies in the U.S. with $182.0 billion in assets and market capitalization of $23.2 billion. Based in Winston-Salem, N.C., the company operates approximately 1,850 financial centers in 12 states and Washington, D.C., and offers a full range of consumer and commercial banking, securities brokerage, asset management, mortgage and insurance products and services. A Fortune 500 company, BB&T is consistently recognized for outstanding client satisfaction by J.D. Power and Associates, the U.S. Small Business Administration, Greenwich Associates and others. More information about BB&T and its full line of products and services is available at www.BBT.com.

We respectfully submit that:

- We support increased minimum capital requirements relative to pre-crisis levels. This is effectively addressed by the narrowed Tier 1 capital instrument definition, new minimum ratios, and the capital conservation buffer in the Basel III implementation proposal.
- The Standardized Approach proposal is excessively complex, burdensome, and is likely to have significant adverse unintended consequences.
- The capital filter for Accumulated Other Comprehensive Income (AOCI) continues to be the best compromise for resolving the balance-sheet accounting mismatches embedded in U.S. Generally Accepted Accounting Principles (GAAP). We request that the AOCI filter be retained, and failing this, AOCI due to changes in benchmark interest rates should be excluded from regulatory capital.
- Risk weights for loans should not depend on past due or nonaccrual status.
- There should be a single, advantaged classification for soundly underwritten, first-lien residential mortgage exposures. Residential mortgage exposures that do not qualify for this advantaged classification should receive 100% risk weight.
- The combination of first- and junior-lien residential mortgage exposures is unworkable and will lead to adverse, unintended consequences. First and junior lien exposures should be treated separately.
- Surplus pension assets at an insured depository institution should be recognized in capital when the pension plan sponsor is the parent bank holding company.
- Real Estate Investment Trust (REIT) preferred stock with the required regulatory swap feature should be treated as the instrument to which it converts and not be subject to the minority interest deduction.
- Additional Tier 1 instruments should not be required to allow the payment of a nominal (penny per share) dividend on common stock.
- No restrictions should be placed on parity dividend or repurchase clauses for additional Tier 1 instruments.
- Eligible retained income for the payout ratio within the capital conservation buffer should match what accrues to regulatory capital (e.g. exclude amortization of intangibles and goodwill write-offs).
- Mortgage servicing rights (MSR) assets which are originated by the institution (as opposed to purchased MSR) should be risk-weighted at 100% and exempt from threshold deduction.
- Increasing principal balance, rate-cap, and interest-only criteria for Category 1 classification should not apply to revolving lines of credit secured by residential real estate (HELOCs).
- The treatment of limited (e.g. early default) warranties on sold loans should reflect the significantly lower risk relative to holding loans on balance sheet.
- The definition of high-volatility commercial real estate (HVCRE) should exclude owner-occupied real estate and occupied properties which are earning income sufficient to cover contractual debt-service.

These positions are supported and discussed in the rest of the letter, organized as follows:

- Level and quality of capital
- Complexity

- *Standardized Approach for Risk-Weighted Assets, etc.*
    - Past due loans
    - Residential mortgage exposures
    - HVCRE
    - Bank-Owned Life Insurance (BOLI)
    - Credit-enhancing representations and warranties
    - "Grandfather" treatment for legacy assets
- *Regulatory Capital, Implementation of Basel III, etc.*
    - AOCI: Available for Sale (AFS) securities, Cash-flow hedges, and Pension
    - Pension assets
    - Mortgage servicing rights assets
    - Capital conservation buffer eligible retained income
    - Deferred Tax Liability (DTL) netting
    - Minority Interest and REIT preferred stock
    - Penny common dividend requirement for additional Tier 1 instruments
    - Parity dividends for additional Tier 1 instruments

Level and Quality of Capital

BB&T supports increased minimum capital requirements relative to pre-crisis levels. The emphasis on tangible common equity and the higher minimum capital ratios in the proposal effectively address this concern. The following table shows the Basel I-equivalent percentage increase in tangible equity required to achieve Prompt Corrective Action (PCA) well-capitalized classification under the proposed rules:

	Current	Proposed	% Increase in Tangible Equity
Risk-based T1 Well Capitalized Min	6.0%	8.0%	
Less Non-Core (15% of Min T1)	*0.9%*	*0.0%*	
Core T1 Well Capitalized Min	5.1%	8.0%	57%
Plus Risk Weight Impact	*0*	*1.7%*	
Core T1 Ratio to Basel I RW	5.1%	9.7%	90%

This simple comparison reflects the elimination of the restricted, non-core Tier 1 capital instruments, but excludes situation-specific adjustments to the definition of capital such as threshold deductions, surplus minority interest, or AOCI. Before applying the proposed risk weights introduced in the Standardized Approach, the narrowed definition of Tier 1 capital instruments and new capital ratios increase the level of tangible equity to meet the PCA well-capitalized benchmark by nearly 60% – a substantial reduction of leverage.

The risk-weight impact shown in the table reflects the proposed Standardized Approach as applied to BB&T's exposures. The changes are almost exclusively increases in risk-weight or expanded scope. As a result, much more tangible equity is required for the same portfolio when compared to the current rules. The resulting PCA well-capitalized level under the proposed rule is equivalent to 9.7% of Basel I risk-weighted assets, a 90% increase.

The capital conservation buffer goes further, setting up hard rules governing capital distributions under stress where SR 09-4 had previously established principles for management and supervision. The capital distribution restrictions within the buffer effectively enforce an 8.5% Tier 1 ratio floor. Including the impact of the Standardized Approach risk weights, this is equivalent to 10.3% of Basel I risk-weighted assets (RWA) – a 101% increase over the current well-capitalized threshold.

BB&T uses stress testing and economic capital to set "buffers" relative to regulatory capital thresholds. The proposed rules introduce significant additional volatility into the regulatory ratios. Large new buffers would be required for increased risk-weight on past-due loans and AOCI if these provisions are retained. Based on analysis of our own exposures and that of peers, buffers for each could reasonably range from 25 to 200 basis points of RWA depending on an institution's portfolio and risk tolerance.

The Comprehensive Capital Analysis and Review (CCAR) process is potentially much broader and more risk sensitive than any of the Basel accords and sets a high, if uncertain, standard for capital. The capital impact of the stress, and remaining capital needed to continue as a credit intermediary determines a risk-sensitive capital adequacy buffer. In addition, the CCAR process requires substantial buffers due to uncertainty about the supervisory scenario and how the Agencies' projections will vary from our own. The impact of the proposed rules is additive to the requirements that arise from CCAR, which are significant in their own right.

To recap, proposed rules substantially raise BB&T's total capital requirement due to:

1. Narrowed definition of regulatory capital (smaller numerator)
2. Expanded definition of exposures (larger denominator)
3. Much higher effective minimum ratios defined by the capital conservation buffer
4. Cumulative impact with CCAR and increased volatility of the capital ratios, primarily due to the increased risk weights on past-due loans and the removal of the AOCI filter (larger buffers required)

The need to accrete additional capital will significantly constrain the banking industry's ability to support economic growth, depending on the final rules. The phase-in periods for the various new requirements help to mitigate the shock of these changes. Grandfathering existing exposures would significantly reduce the shock to affected legacy asset values. However, both of these mitigating provisions increase complexity and confusion. *We ask that the Agencies maintain or strengthen phase-in provisions, but simplify them where possible.*

Complexity

The complexity of the proposed rules is troublesome and the aggregate impact is uncertain. Together, the three proposed rules implement a large number of dramatic changes to a prescriptive, rules-based framework. The proposals are more prescriptive with regard to specific exposure treatment in spite of ample evidence from the recent crisis of the distortions this produces. Given more robust capital requirements, we believe that a simpler risk weighting system is superior to complex, prescriptive risk-weighting rules.

As mentioned in the previous section, the CCAR process offers promise as a principles-based approach to risk-sensitive capital management. In concert with simple, clear capital ratio definitions and high standards for the level and quality of capital, we believe that the CCAR process creates healthy incentives for risk measurement and management.

We urge that the Agencies introduce only the changes needed to conform capital ratio definitions and levels to international standards (as appropriate in the U.S. context). These improvements put the Agencies in a good position, with time to study the impact and revisit the need for additional changes based on what is learned.

Standardized Approach for Risk-Weighted Assets, etc.

The Standardized Approach rule is complex, burdensome, and prescriptive, has not been quantitatively supported in its presentation, and the joint impact with the other capital rules is likely to significantly distort credit markets with adverse impact for consumers and the economy. *We strongly recommend that the Agencies withdraw the Standardized Approach rule as proposed and put into place a program of study to evaluate the need for enhancements to the current risk weighting regime.*

Past Due Exposures

Application of substantially higher regulatory capital rates to non-performing assets runs counter to the principle of risk capital – sufficient risk capital must be allocated at origination to protect against adverse outcomes over the life of an exposure. We cannot wait until risk crystallizes into probable losses to allocate capital, the capital must already be present to support the necessary increase in the allowance for loan and lease losses. Increasing the capital requirement for troubled assets will strongly incent banks to sell them rather than work with clients through difficult times. We believe this will lead to less favorable outcomes for the majority of borrowers, intensify the credit cycle, and increase systemic risk. *We believe that proposed treatment of past-due exposures is not sound macro-prudential policy and urge the Agencies to reconsider this aspect of the proposal.*

Residential Mortgage Exposures

It is our firm belief that lax underwriting standards and over-reliance on collateral were the primary causes of the recent crisis in residential real estate. Some of the loan products implicated in the proposed rules were susceptible to abuse because they require more careful underwriting than standard products. It was the lack of prudent underwriting – a failure to verify that the loan product was reasonably within the capacity of the client – that made these loans toxic. *If the Agencies retain the Standardized Approach in some form, we ask that the criteria for preferred treatment of residential mortgage exposures be simplified to focus on underwriting standards.*

The "Category 2" classification with the punitive capital treatment proposed is unnecessary and unwarranted for many affected assets. There are clients for whom these features are appropriate and do not create undue risk. Policy objectives related to misuse of specific loan features are better served through the channels of supervision directly focused on products and lending practices. Simply excluding residential mortgage exposures that do not meet conservative underwriting standards from the preferred class is an appropriate treatment. *We ask that a final rule include a preferred class for high-quality residential mortgage exposures, including first-lien HELOCs, and that exposures that do not qualify receive a 100% risk weight.*

The proposed rule does not present any empirical data or other evidence to support the very substantial proposed increases in risk weights for the mortgages assigned to Category 2 or for the relative calibration of such increases based on the loan to value ratio (LTV). We are supportive of the principle that underwriting standards and LTV are meaningful differentiators for residential real estate risk. However, the details of the proposal do not align with our experience in many instances and would significantly impact the structure and pricing of loans that BB&T would make. Our concerns and questions for particular provisions of the residential mortgage exposure risk weight proposal are as follows:

<u>Combination of First and Junior Liens</u>: We appreciate the principle behind the provision which requires that first and junior liens on the same property be combined for LTV and category classification purposes. It is also easy to see how the Agencies might believe that the potential for junior liens to receive preferential Category 1 treatment could be a favorable outcome that would provide healthy incentives for the industry. In practice, however, the effect is bad for all involved.

In total, we have found that combining first and junior liens increases RWA within our current residential mortgage exposure (RME) portfolio by 11.4% in total relative to separate treatment – a $4 billion increase. The impact on the affected first lien loans is a 300% increase of risk weights which is primarily driven by the combination of low-LTV first liens with standard HELOC products which we interpret to be Category 2.

When the junior lien qualifies as Category 1, the effect is essentially the same as refinancing the first lien position to include the second exposure. The effect of the proposed treatment is sensitive to the specific structure of the two loans, but in most instances it will lead to a slightly lower lifetime average risk weight when compared to separate treatment and is not objectionable.

However, when the junior lien does not qualify as Category 1, the combination effect is profound. The lifetime average risk weight for combined exposures is approximately double what it would be if the first and junior lien were held by separate institutions. It would be very costly for BB&T to extend a Category 2 junior lien if we held the first, but a competitor could easily extend a comparable product to the same client. This treatment is inconsistent with the enhanced risk management capability that we have when we hold all liens on a property. It is also contrary to our experience that shows a standard first mortgage combined with a properly-underwritten HELOC performs at least as well as a stand-alone first lien of the same total LTV.

In many specific instances, and in aggregate for our current portfolio, the proposal requires less capital across the industry if first and junior lien positions are divided between banks rather than managed at a single institution. This aspect of the proposal will have destructive effects on the mortgage credit markets and we believe that this was not the Agencies' intent. *We ask that first and junior exposures be treated separately to maintain consistent capital treatment across banks.*

<u>HELOC treatment</u>: It is unclear from the structure of the rule if all of the RME criteria are intended to apply to HELOCs or whether they are governed solely by the item in which they are named. If the other criteria apply, the standard HELOC products are excluded from the proposed Category 1 definition because they:

1) allow the client to increase the principal balance,
2) make interest-only payments during the line's draw period,
3) are indexed to Prime with no rate cap, and
4) due to 3), cannot be qualified using the maximum interest rate that could occur during the first five years of the exposure.

BB&T underwrites HELOCs using a borrower's ability to pay 1.5% of the total line amount. This fixed percentage is equivalent to an amortizing monthly payment for a loan of the full line amount with a 16.5% interest rate over a 15-year term. This approach, in combination with stringent LTV requirements (or CLTV for junior liens) has resulted in better default performance for HELOCs than comparable closed-end mortgages[3]:

Ratio of HELOC Default Rate to Closed-End Default Rate
Data from 1/1/2006 to 12/31/2011

Beacon Score	First Lien	Junior Lien
0 to 619	87%	95%
620 to 679	73%	72%
680 to 739	45%	55%
740 and over	20%	30%

HELOCs are an important form of credit with a long track record of proven performance. When underwritten prudently, they perform at least as well as comparable closed-end loans and should not be excluded from Category 1 treatment due to the standard product features. *We ask that the Agencies clarify the structure of the rule to exempt revolving lines of credit secured by residential real estate from the category treatment criteria listed as 1) through 4) above.*

<u>Five-year underwriting horizon for ARMs</u>: The provision to qualify ARM products based on the maximum interest rate over the first five years creates incentives to offer ARM products with an initial fixed term of five years or greater. This may not have been the Agencies' intent, but this provision is likely to have perverse effects on the ARM

[3] HELOC and closed-end loans originated through BB&T's direct retail lending channel.

products offered to consumers. *We ask that the agencies remove the five-year underwriting horizon criteria for Category 1 exposures.*

Affordable Lending and Community Reinvestment Act (CRA) Exposures: The majority of portfolio affordable lending products, especially those that receive CRA consideration, utilize higher LTV percentages to provide financing for borrowers who could not be served under traditional underwriting guidelines. The proposed LTV stratifications would significantly increase the cost of most affordable lending products. This would impede institutions' ability to provide financing to under-served borrowers at rates they can afford. The effect of the proposed rules conflicts with the policy objectives established through the CRA. *We ask that the Agencies cap the risk weight scale at 50% for Category 1 CRA exposures and other qualified affordable lending products to align with the objectives of these important programs.*

HVCRE

The Agencies should clarify the HVCRE definition to exclude owner-occupied real estate (OORE) loans, given that the source of repayment is not dependent upon the real estate. We also ask that the definition exclude loans to acquire substantially-complete projects that are earning income sufficient to carry contractual debt service. Both of these classes of loans present a lower risk of default and warrant lower risk weights.

With respect to contributed capital criteria, minimum cash equity should be measured as a percentage of total project cost rather than appraised value. The potential profit margin for the developer of a project has no bearing on the risk a bank assumes in providing financing for a project. Also, minimum cash equity should be bifurcated with a 10% equity requirement for the acquisition or construction of commercial income properties and a 15% equity requirement for raw land or horizontal development.

We agree that the original equity should remain through the life of the project; however, excess cash flow generated by the project should be distributable to investors to provide ongoing cash-on-cash returns.

Lastly, we ask that the Agencies confirm that the definition of conversion from a construction loan to a permanent loan is consistent with the Consolidated Reports of Condition and Income.

BOLI

BB&T currently utilizes the Alternative Modified Look-through approach to risk weight BOLI Separate Accounts which applies risk weights based on the investment guidelines of each investment division.

The Full Look-through Approach creates significant hurdles to overcome:

- Some insurance carriers will not provide CUSIP detail of the investment divisions due to perceived Investor Control issues.
- The total number of CUSIPs in the different investment divisions of the Separate Accounts could be substantially greater than the bank's own investment portfolio, causing undue burden to risk weight these portfolios.

We recommend two approaches to address these issues:

1) *Allow the Gross-up Approach described in section 43(e) to be applied to Investment Funds, regardless of a bank's subjectivity to Subpart F. This would provide a way for investment guidelines to be written to allow investments in the highest quality securitization assets and for effective monitoring that the investments meet the proposed rules.*
2) *For Investment Funds only, the same result as the Full Look-through Approach could be achieved through an asset allocation summarization based on Subpart D guidelines. This would eliminate both of the hurdles discussed for the Full Look-through Approach but would still require the adjustment for securitizations recommended in 1.*

<u>Credit-Enhancing Representations and Warranties</u>

Premium refund clauses should not be considered credit-enhancing representations and warranties, nor should they require any additional risk-based capital. They do not protect the investor from credit losses to the value of the asset; they offer the option to the investor to recapture the relatively tiny sale price premium in certain cases of early prepayment. A 100% credit conversion factor (CCF) is out of line with this exposure to the originating institution. *We ask that the Agencies clarify that premium recapture clauses are not credit-enhancing representations and warranties and therefore do not create risk-weight exposure.*

With regard to early default warranties, we ask that the Agencies carefully consider the CCF for these limited credit guarantees. The 100% CCF proposed in the rule and the discussion in the preamble suggest that the Agencies equate the risk of providing such credit enhancement with the risk of holding the covered asset for the contract period.

It may be the intention of the Agencies to provide a strong disincentive for banks to participate in the market for credit guarantees. If so, the proposed treatment achieves those intentions. However, please consider that early default guarantees are a transparent and natural way to align the interests of the originator of assets with the interests of third-party investors. The resulting increase in trust broadens and increases the efficiency of credit markets.

If it is not the intent of the Agencies to stop banks from providing limited credit enhancement on assets originated for sale, then the capital treatment of such arrangements must be more closely aligned with the economic risk. The CCF should reflect the risk of the off-balance sheet exposure relative to the risk of an owned asset.

The provider of credit coverage and the holder of a comparable asset are exposed to the same default risk during the warranty period. However, at the time the warranty expires, the coverage provider is free and clear of any future default risk in the performing loans. If credit conditions deteriorate significantly over the coverage period, the value of the performing loans may fall dramatically, but the institution that provided the guarantee is only exposed to the actual defaults and not the change in value of performing loans.

The difference in credit risk between a limited default guarantee and holding a position on balance sheet is driven by the term of the guarantee relative to the life of the asset and the breadth of the coverage (likelihood of repurchase obligation trigger). Conservatively ignoring the benefit of limited trigger terms, the CCF should be the ratio of the discounted asset cash flows in the coverage period (protected value) to the full value of the asset. *We ask that the CCF for limited, early-default, warranties reflect the significantly lower risk exposure compared to on-balance sheet loans – a 2% to 10% CCF would be appropriate for coverage less than a year on sold mortgages.*

Grandfathering Legacy Exposures

Given the unanticipated and significant changes in risk weight treatment proposed, we ask the Agencies to consider grandfathering portfolio exposures pre-dating a final rule. We believe this is essential to prevent an adverse shock to the value of assets which receive unfavorable changes in risk-weight treatment.

Some proposed risk-weight criteria require extensive data that are not readily available for many legacy assets. This is particularly acute for HVCRE and RME where underwriting or project maintenance criteria are applied (as opposed to product structure criteria). Many of these loans might meet the standards set in the rule but the data are not available in the loan information systems for risk weighting purposes. Specifically exempting legacy assets from the documentation criteria while still applying structural criteria would ensure these assets are not unduly penalized simply due to a lack of data that were not required at the time of origination. This intermediate grandfathering strategy would not require parallel Basel I vs. Standardized Approach reporting as legacy assets run off.

The effective vintage date for the new rules should allow institutions time to adapt systems and processes so that punitive risk weights are not applied simply due to lack of data.

Regulatory Capital, Implementation of Basel III, etc.

AOCI

AFS Securities: Including the OCI mark on securities will have many detrimental effects on how banks manage their balance sheets. Specifically if this rule is adopted as provided in the proposed rule it will:

- Create an un-hedgeable capital risk on banks' balance sheets for securities held in the Available for Sale Category.
- Set a precedent for carving out a specific risk and treating it differently from all other risks without any recognition that there are offsetting risk mitigants on the balance sheet. In this case, the Agencies would be focusing capital on an accounting risk versus a real economic risk. While this risk has the potential to be an economic risk, treating it in a vacuum ignores any economic hedging of the balance sheet.
- Create capital volatility which could force banks to increase capital held for a risk that will likely never be realized through the income statement.

- Force banks to hold shorter duration investment portfolios and shrink the size of the portfolio to mitigate capital volatility and require disproportionately high levels of capital against a low risk asset.
- Create a capital regimen that is inconsistent with the safe and sound management of interest rate risk.

Banks manage interest rate risk based upon an evaluation of the entire balance sheet. Banks have offsetting liabilities that create an economic hedge of some or all of the risk in the investment portfolio. However, the selective application of mark-to-market valuation to the AFS securities does not take offsetting economic value change in other parts of the balance sheet into account.

Banks could potentially offset OCI risk to regulatory capital by putting on pay-fixed cash flow hedges, but the rules have specifically eliminated the OCI mark from cash flow hedges from capital unless they are hedging a balance sheet item for which the institution has elected the fair-value option. Further, if the bank did elect the fair-value option for the liability, the hedge of the liability would not provide any OCI protection because any gain on the hedge would be offset in equity by the liability mark, leaving no benefit to the OCI from the securities portfolio.

This rule introduces into capital the conflicts between accounting measures of value and sound economic interest rate risk management. While there is clearly a linkage between valuation and interest rate risk, traditional balance sheet banks that are primarily concerned with margin income tend to hedge for consistent margin versus hedging for fair value effects. The hedging of margin is not compatible with hedging immediate changes in rates and the resulting impact on fair value and equity. When a bank hedges its margin, it is looking at how to manage pricing mismatches in the balance sheet over a forward horizon. This type of hedging does not need to be a full duration-based hedge with an equivalent DV01 for each asset and liability as the balance sheet has natural re-pricing occurring as well as new volume coming on each day. It also has fixed sources of funding including the equity account and demand deposit balances. Interest rate managers take all this into account in simulation models when determining how to hedge the balance sheet. Most banks hedge the margin over a several year forecast horizon knowing rates will change, balance sheet mix will change, and hedges can be adjusted over time without resulting in unreasonable risk to the institution. Commercial banks have a long and successful history of hedging in this fashion. Banks also run economic value of equity (EVE) models to evaluate interest rate mismatch risk beyond its typical forecast horizon.

Fully hedging asset duration is not necessary because banks only have to hedge to allow duration mismatches in the balance sheet to re-price as rates move. Long-dated securities provide cash flow which is reinvested as rates change. This provides another economic offset that is not reflected in OCI, but is taken into account when banks run their simulation models to determine their interest rate risk. Banks try to manage their balance sheets so the remaining un-hedged "tail" of very long-dated fixed-rate assets are offset by liabilities that are either similarly long dated such as bank notes, demand deposits that behaviorally are very stable, long-duration liabilities, or the equity account. These liabilities and equity are not marked through OCI but they do ensure the margin on the asset is realized.

Including OCI in capital also adds a new risk dimension to the CCAR exercise. CCAR requires that banks maintain a stressed capital level to pass the exercise. The addition of the OCI volatility provides an added measure of uncertainty to this very important supervisory process. For example, the potential for a stagflation scenario on top of a recession could put more banks in a situation where their capital plans receive an objection even though the OCI component will never be recognized directly in capital. In fact, it could be argued that OCI double counts the interest rate risk in a CCAR exercise. OCI reflects the lower amount of income that will be received from the securities over their life as compared to current market levels of return. In the CCAR exercise, Pre-Provision Net Revenue (PPNR) is a critical component, so the bank would recognize any lost revenue in PPNR as well as the direct hit to capital from the OCI mark so there is a potential for counting this risk twice in a CCAR exercise. However, if the bank is properly hedged, the PPNR would not be reduced and the OCI-caused equity reduction would never be realized as it reflects a completely un-hedged recognition of future cash flows.

As noted above, banks do have economic hedges that offset OCI, but the economic hedges are not marked-to-market through equity. A simple example: A bank could buy a 10 year Treasury security and fund it with a 10 year bullet debt. The transaction entails no credit risk or margin risk, but capital would be reduced due to OCI if rates rise. We feel that this is not appropriate.

The Agencies put forth the following questions:

> "To what extent would a requirement to include unrealized gains and losses on all debt securities whose changes in fair value are recognized in OCI (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."
>
> "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)?"

Some of the issues raised by these questions were addressed above. BB&T believes the inclusion of AOCI in capital will result in excessive volatility in regulatory capital, including in the all important CCAR exercise, and will cause banking organizations to hold shorter average duration portfolios, thus permanently lowering retained earnings and thereby capital in the system. Additionally, including AOCI in capital will result in banking organizations holding reduced levels of liquid assets. This outcome will be driven by two challenges: 1) the shorter duration securities needed to avoid OCI risk will not generate a sufficient return to justify the higher levels of capital, particularly Tier 1 common, required under Dodd Frank / Basel III; and 2) holding longer duration portfolios will increase risk to capital and thus require expensive capital buffers to be held on an otherwise low risk asset just for this accounting created measure of interest rate risk. The combination of these two factors will force banks to hold lower levels of securities and drive banks to meet Liquidity Coverage Ratio requirements through liability management strategies versus asset based buffers.

In response to the question about excluding AOCI associated with U.S Government and Agency debt obligations from capital, we believe this would be a significant benefit to banking organizations. However, we also feel this approach ignores the very accounting rules that are being used to justify this ill-advised capital treatment in the first place. GAAP requires that all "Other Than Temporary Impairment" i.e. all non-interest rate related impairment to the carrying value of a security be recognized in earnings immediately. This leaves all securities with only interest rate risk reflected in the OCI mark plus any changes in spreads reflecting risk premiums in the market place from time-to-time. *We agree that changes in value due to "changes in fair value predominantly attributable to fluctuations in a benchmark interest rate" as stated in the question above should be excluded from OCI, but accounting rules already do this, so we believe it only makes sense to reestablish the OCI filter for all securities.*

The only justification for including only Government and Agency securities in an OCI filter is the liquidity advantage these securities display regardless of market conditions. The market for these securities was always deep even during the height of the financial crisis. The result is that these securities never suffered a liquidity discount due to lack of market depth and bid / ask imbalances. Government and Agency securities offer strong liquidity to banks even as rates rise. Liquidity can be obtained through repo and other pledging transactions. Government and Agency securities were readily accepted as high quality collateral throughout the financial crisis. If part of the underlying principle for including OCI in capital is to show the effect to the institution of obtaining liquidity from its security portfolio, this need not be achieved through a sale of the portfolio and the monetization of the OCI because it can easily be obtained in financing transactions. Similarly, in the event of a soft economic environment, banks do not need to have the OCI benefit from a positive mark-to-market on the portfolio when rates are falling to gain the capital benefit of the OCI. This positive mark-to-market can be easily monetized by selling securities in the AFS portfolio and realizing the gain. In fact this may be preferred in the case of mortgage-backed securities because the gain can be lost to prepays if they are held, so monetization may be a preferred option.

Lastly, if the final rule includes only Government and Agency securities in an OCI filter, we believe Agency mortgage-backed securities should also be included as they experienced trading patterns similar to Agency debentures and Government securities throughout the crisis.

Cash-flow Hedges: If the Agencies adopt the rules such that OCI from the mark-to-market on the securities portfolio remains in capital, we believe banks should have the option, but not the obligation, to include the OCI mark-to-market from cash flow hedges in capital as a risk mitigant. Cash flow hedges would be the most efficient way for a bank to hedge OCI volatility from securities if the Agencies adopt the rule with the filter removed. Without this option to hedge OCI volatility, banks may choose to:

- Shorten the duration of the securities portfolio which will reduce PPNR in the industry and thus permanently reduce capital in the system over time.
- Incent the adoption of complex and potentially counterproductive hedging schemes to reduce the capital volatility.

Lastly, if banks choose to shorten the life of their investment portfolio, it will remove an important bid from the market for longer-dated securities like Agency mortgage-backed securities which could impact the cost and availability of certain types of credit.

Pension AOCI: The pension OCI mark is problematic in much the same way as for AFS securities. The primary source of OCI volatility in this case is the benchmark discount rate used for valuing the pension obligations. The relatively long pension liability results in a partial hedge for the volatility from AFS AOCI. *Due to this common linkage to benchmark interest rates and the partial hedging relationship, we ask that pension AOCI and AFS AOCI due to changes in a benchmark interest rates be treated consistently, preferably both filtered.*

Pension Asset

As part of a very small minority of banks with a pension surplus, we appreciate the explicit recognition of overfunded pension assets in cases where the FDIC has unfettered access in the event of resolution. *We believe that this is intended to apply in cases where the surplus pension assets are assets of the insured depository institution and the pension plan sponsor is the parent bank holding company. We request that the Agencies clarify the treatment of this issue.*

We believe that restrictions on the recognition of pension assets are unsupported and respectfully request that pension assets be recognized without qualification for the following reasons:

- Curtailment of funding to a pension with surplus is a meaningful source of cash which can be used to meet other obligations. This is especially so if the AOCI filter is left in place. With the AOCI filter removed the effectiveness is reduced but not eliminated.
- Deduction of pension assets from capital creates incentives for bank holding companies to minimize funding of the pension or eliminate pension plans altogether. Thinner funding exposes the PBGC to greater risk which is ultimately passed on to all guaranteed pension plan sponsors in the form of higher premiums. This reduces the efficiency of a primary private-sector alternative to public social welfare programs. By transferring this perceived risk from the FDIC to the PBGC, this treatment replaces constructive incentives with less wholesome ones. The result is a net negative impact to general public welfare.
- The deduction of pension assets from regulatory capital produces no real-world positive effects in the United States. The very small number of banks that maintain a pension surplus do so primarily as part of a strategy to attract and retain talent over the long term.
- The capital impact of funding a pension in surplus is a part of capital planning and as such is subject to oversight by the institution's primary regulator who is in a position to consider the safety and soundness of an institution in whole.

In light of these points, we ask that the Agencies place no restriction on the recognition of surplus pension assets in regulatory capital.

MSR Assets

The value of MSR assets was not a significant driver of industry difficulties during the recent crisis. The proposed 250% risk weight and threshold deduction treatment for MSR significantly increases the capital costs for this line of business. In particular, it strongly discourages building mortgage servicing capabilities beyond a certain limited scale which will increase the cost of mortgage credit and drive servicing activities out of the banking industry. Banks are strongly incented to hedge the value of MSR through the accounting treatment of the asset. The risk from MSR is net of the hedged exposure. *We believe that the current treatment of MSR assets (100% risk weight and no threshold deduction) is effective and feel that a 250% risk weight is unwarranted.*

The ability to originate new servicing to replace servicing lost to prepayment in a falling-rate environment provides a meaningful hedge not reflected in the proposed treatment. We understand that the Agencies may be concerned that the holder of purchased MSR assets may not have the operational capacity to realize this offset to prepayment risk. *In this case, we propose that purchased MSR assets be treated as proposed (250% risk weight and threshold deduction) and originated MSR assets continue under the current treatment.*

Capital Conservation Buffer Eligible Retained Income

We ask that the agencies clarify that income/expense related to items deducted from regulatory capital (e.g. amortization or write-down of intangible assets and goodwill) would be excluded from eligible retained income for the purposes of calculating payout ratios within the capital conservation buffer. This revised treatment supports what appears to be the intent of the rule – to govern the accretion of Tier 1 common equity when the risk-based ratios approach important thresholds.

DTL Netting

The proposed rule does not indicate that DTL netting against goodwill and intangibles will be subject to the existing restrictions, whereby netting is only allowed on intangibles if the DTL arose as a result of a tax free acquisition. In the proposed rule it appears any DTL is eligible for netting. *We ask that the Agencies' clarify the intent to broaden the rule in this way.*

Minority Interest and REIT Preferred Stock

We appreciate the attention devoted to establishing REIT preferred stock as a Tier 1 capital instrument. With some minor changes to the proposal this could correct a meaningful source of competitive inequity between U.S. rules and those governing foreign peers by providing an option for tax-advantaged Tier 1 capital. The exchange feature required under the rule will significantly change the market for REIT preferred stock, but it also establishes the resulting instrument as a substantial form of "going concern" capital.

There are two features of the proposed rule that make REIT preferred stock largely unworkable: the "operating entity" requirement for additional Tier 1 instruments; and the surplus minority interest rules. First, the structural and management constraints imposed by the REIT requirements limit flexibility to act as an "operating entity" that deals directly with clients. Second, to be an efficient source of capital to the parent, nearly all of the funding must be REIT preferred stock. This funding structure results in a large capital surplus which is then deducted from the parent's capital under the minority interest calculation.

Both of these issues are resolved by treating all instruments which are exchangeable at the supervisor's discretion as the instrument to which they convert for the purpose of regulatory capital. Once converted, the noncumulative perpetual preferred stock is governed by the capital distribution constraints established through the capital conservation buffer. In the case of REIT preferred stock, this provides meaningful "going concern" financial flexibility and "gone concern" loss absorption for the parent, which justifies Tier 1 treatment.

Penny Common Dividend Allowance for Additional Tier I Instruments

Regarding *Question 19* posed under "Additional Criterion Regarding Certain Institutional Investors' Minimum Dividend Payment Requirements." A revision requiring a banking organization to have the ability to cancel or substantially reduce dividend payments on additional Tier 1 capital instruments during a period of time when the banking organization is paying a penny dividend to its common shareholders would have a significant negative influence on both the cost and availability of non-common Tier 1 capital. A feature called a "dividend stopper" is a market standard feature of preferred stocks. This feature gives preferred shareholders confidence that they will not be disadvantaged relative to common shareholders.

The following are market-standard features of preferred stock indentures:

1. If dividends are not paid on preferred stock, a dividend cannot be paid on common stock.
2. Prevent repurchase of common stock if dividends are not paid on preferred stock.
3. Require proportional repurchase of all parity preferred stock if dividends are not current.

If additional Tier 1 capital instruments are required to allow for payment of a penny on common stock it will effectively require banks to recall all current noncumulative perpetual preferred stock. This exposes issuers to substantial expense and market uncertainty, while lowering capital in the banking system until all issuers issue preferred securities that meet the new standard. *The Agencies should not implement the "penny dividend" provision raised in the question regarding criterion (7) of additional Tier 1 capital instruments.*

Parity Dividends for Additional Tier 1 Instruments

The proposed rule does not address the ability to treat all series of perpetual preferred stock the same when it comes to their dividend. Another market standard for dividend stoppers requires equal treatment across all series of *pari passu* stock and any junior stock. The Agencies should clarify in the final rule that parity treatment of pari passu and junior stock does not cause disqualification as non-common Tier 1. In a Basel Committee on Banking Supervision FAQ release on the Basel III capital rules, the BCBS clarified that: "...dividend stopper arrangements that stop dividend payments on common shares or dividend/coupon payments on other Additional Tier 1 instruments are not prohibited by the Basel III rules text." *The U.S rules should not establish more restrictive conditions regarding "dividend stopper" clauses than those contemplated in the Basel III accord for additional Tier 1 instruments.*

Concluding Remarks
We appreciate your consideration of our comments related to the proposed regulatory capital rules. If you have questions or require further information please contact me.

Respectfully submitted,

Daryl N Bible

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