



Bank of Oklahoma Tower  
P. O. Box 2300  
Tulsa, Oklahoma 74192

September 12, 2012

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

Board of Governors of the Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, N.W.  
Washington, DC 20551  
Attention: Jennifer J. Johnson, Secretary

Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, DC 20429  
Attention: Comments/Legal/Robert E. Feldman, Executive Secretary

Re: Comments on Basel III and Standardized Approach NPRs  
OCC Docket ID OCC 2012-0008, OCC Docket ID OCC-2012-0009  
Federal Reserve Board Docket No. R-1442  
FDIC Docket RIN 3064-AD95, AD96  
Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III,  
Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions,  
And Prompt Corrective Action

Ladies and Gentlemen:

BOK Financial is a \$25 billion full-service commercial banking organization with branches serving Oklahoma, Texas, New Mexico, Arizona, Colorado, Kansas, and Arkansas. We appreciate the opportunity to provide comments on this important set of capital proposals. We are very supportive of the broader goals of capital policy improvement and seek an efficient and effective outcome. Our primary concern relates to interest rate driven capital volatility, and we highlight several perspectives on this topic in support of the alternative approach outlined in the NPR. We also have comments on several other provisions, which follow our discussion of capital volatility.

BOK Financial has one of the strongest balance sheets and among the best capital adequacy levels in the country. None of the changes in the NPRs would pose a challenge for BOK Financial. However, we are concerned about how the proposals would affect the banking system broadly and the overall US economy in a rapidly increasing interest

rate scenario. Both aggregate domestic lending capacity and interest rate risk management practices across the banking system would be materially negatively impacted by this proposal as written.

**Capital volatility and the risk of a decrease in lending capacity**

Under the NPRs as proposed, when market rates increase, capital in the banking system will decrease. When capital decreases, lending capacity will decrease. Based on the existing bond portfolios of banks, this could reduce aggregate U.S. lending capacity by as much as \$2 trillion to \$3 trillion in a scenario where interest rates rise by 400 basis points.

**How would the proposals reduce capital when interest rates rise?**

There are three mechanisms by which regulatory capital would be reduced.

First is the Available for Sale (AFS) bond portfolio mark-to-market (MTM) through the Accumulated Other Comprehensive Income (AOCI) capital account. When market interest rates increase, the value of the bond portfolio will decrease. To illustrate, every \$1.00 of pretax decrease in bond portfolio market value will require a bank to subtract the after-tax portion of that amount (\$0.65) from Tier 1 Common Equity (T1CE) through AOCI.

Second, the \$0.35 tax effect will add to the Deferred Tax Asset (DTA) which, once over the 10% limit or 15% combination limit, will be subtracted dollar for dollar from T1CE.

And third, also driven by the increase in rates, the Mortgage Servicing Rights (MSR) asset will increase in value. As with the DTA, the MSR value increase, once over the 10% MSR limit or the 15% combination limit, will be subtracted dollar-for-dollar from Tier 1 Common Equity.

The DTA and MSR are both constrained by the 15% combination limit. They may be near their individual limits or combined limit before interest rates begin to increase. Within the DTA, the Loan Loss Reserve-related DTA could easily be over 7% or 8% of T1CE, and the potential for changes to the Loan Loss Reserve framework as is currently being considered by the FASB could move reserve levels higher leaving little room before breaching the 10% limit. For those banks with MSR assets, the initial amount could reasonably be 5% to 10% of T1CE. Because the DTA and MSR levels which exist before a rate increase may represent a large portion of the 15% combination limit before rates begin to rise, the 15% limit can be breached with a very small rate increase, perhaps as little as 50bp. Beyond the combined limit, the MSR and DTA increases fully subtract from Tier 1 Common Equity and therefore also subtract from lending capacity.

**How much lending capacity would be at risk to an increase in interest rates in the U.S.?**

The amount of capital, and therefore lending capacity, that could be removed from the U.S. banking system would be limited only by the magnitude of the rate increase. There would be no actual limit since the more rates increase, the more capital would be reduced. The amount of the change will be a function of the size of the rate change, the duration of investment portfolios and the size of investment portfolios. The roughly \$2.5

trillion in securities in the investment portfolios of U.S. banks could generate as much as a \$200 billion to \$300 billion decrease in aggregate TICE due to a large and rapid increase in intermediate and long term interest rates. Such a decline in capital could trigger a decline in lending capacity in the \$2 trillion to \$3 trillion neighborhood.

It is instructive to note that this is an interest rate driven mark-to-market. No credit risk impact affected the above figures. Banks do practice effective asset-liability management and there are stable rate liabilities funding these fixed rate securities. As these liabilities are predominantly deposits, it is impossible to calculate a precise mark-to-market for them, however their value has increased by something near the amount of the loss in securities. As the bonds approach maturity, the mark-to-market loss declines to zero. The capital volatility problem is the result of a one-sided mark-to-market of a two-sided book of business. This problem would be manufactured by applying a "trading account" accounting approach to a book of business which does not have a trading account purpose, but because it affects regulatory capital, it has tangible effects which would adversely impact the broader economy.

**Alternatives available to banks and the resulting impacts to asset-liability management and interest rate risk levels**

If adopted as proposed, some banks will identify this issue in advance and wish to manage their exposure. We believe there are only two alternatives, both of which have adverse systemic risk consequences and would conflict with other regulatory policy.

While Basel III and the NPRs would require the unrealized gain or loss on a U.S. Treasury security to run through regulatory capital, it allows the unrealized gain or loss on certain cash-flow hedges to be filtered out of regulatory capital as it would generate "artificial volatility in common equity" (per paragraphs 71 and 72 of Basel III.) This "carve-out" forms the basis for strategy #2 below.

From our perspective, banks could execute two strategies to address the majority of the capital volatility problem:

1. Sell fixed rate bonds and buy short-term T-bills. This would have several undesirable side effects:
  - a. The resulting shift in the duration of the investment portfolio will shift the bank's interest rate risk position from properly balanced to significantly imbalanced. Since all banks would have the same type of structural imbalance, this interest rate bet would "go bad" at the same time for all banks across the system.
  - b. Such a risk position would not be permitted under existing regulations which require banks to prudently manage their interest rate risk positions.
  - c. With banks selling term investment securities in bulk, including mortgage backed securities, U.S. Treasury securities, and municipal bonds, the long end of the yield curve would steepen significantly given the \$2.5 trillion of securities held by U.S. banks.
  - d. Mortgage finance and governmental finance would be adversely affected and home prices would be negatively impacted.

2. Sell fixed rate bonds and enter into derivative contracts or repo/derivative combination contracts with large investment banks to fix the interest rate risk imbalance. This would also have several undesirable side effects:
  - a. The amount of financial system interconnectedness that would result from such a large volume of new derivative transactions would be considerable and represent a very large increase in systemic risk.
  - b. The December 20, 2011 NPR on Enhanced Prudential Standards cited interconnectedness as a risk to financial stability and seeks to prevent just this sort of outcome.
  - c. MBS and other bond spreads would widen significantly, although the swap curve would exhibit little change.
  - d. Many banks would have little or no prior experience with derivatives which would exacerbate the risk issues.
  - e. Hedge accounting restrictions within U.S. GAAP might limit this strategy from a practical standpoint.

The use of held-to-maturity (HTM) accounting treatment for investment securities can not be counted on as an effective durable solution given both the FASB's deliberations on its elimination over the past two years, and the fact that use of HTM effectively disallows active management of interest rate risk positions. The ability to make small but important changes to the securities portfolio is crucial to effective asset-liability management. As a bank's balance sheet or the interest rate environment change, it may be necessary to reposition a portion of the investment portfolio to rebalance the risk position. HTM elections are irrevocable. It is impossible to know at the time of HTM designation which portion of the portfolio might need to be sold to accomplish ongoing risk management objectives. Additionally, the use or overuse of HTM may also negatively impact liquidity risk. None of these outcomes could possibly be considered good public policy in an environment where policy makers are endeavoring to improve risk management at financial institutions.

A likely outcome of adopting the NPRs as proposed would be a combination of banks making no changes, adopting strategy #1 and/or adopting strategy #2. If HTM accounting remains an alternative in U.S. GAAP, some usage of HTM will occur also. Some banks may not fully understand the issue and will do nothing by default. Some banks may understand the problem to be a function of bad regulatory accounting (i.e. one-sided MTM treatment of a two-sided book) which will fix itself by waiting for the bonds to approach maturity, and do nothing intentionally. The net result may be that a large amount of the lending capacity risk will remain in the banking system which, though on a bank by bank basis may or may not be unreasonable, in aggregate will still represent a significant systemic problem.

Because of the practical constraints of the above solutions, under this NPR, banks would not be able to have both a safe asset-liability management position and a safe level of capital volatility at the same time. One of the two would have to be unsafe at any given time. We feel very strongly that this outcome must be prevented.

**Systemic risk resulting from this NPR should be considered by FSOC**

We believe that the magnitude of systemic risk that could be generated by this issue is sufficiently large that the Financial Stability Oversight Counsel (FSOC) should be briefed prior to the issuance of the final rule. As described above, the aggregate US lending capacity at risk is in the \$2 trillion - \$3 trillion range and, while a portion of that exposure would likely be mitigated and converted to other forms of systemic risk, the remaining risk to lending capacity left in the system is likely to be quite large. The magnitude of this issue appears to be material compared to other issues addressed in the Potential Emerging Threats section of the 2012 FSOC Annual Report.

**Systemic risk decisions should not be delegated to the FASB**

The FASB could effectively solve the capital volatility problem in the U.S. by allowing amortized cost accounting treatment for AFS securities. However FASB could also worsen the capital volatility problem by eliminating HTM accounting for securities. The FASB has no mandate to consider the systemic risk implications of their decisions and therefore should not have this decision-making authority delegated to them. US banking regulators should solve this systemic risk issue through capital policy.

**International competitiveness and incentives for mergers and acquisitions**

We recognize that this NPR is simply implementing what is in Basel III. However, AFS accounting for investment securities and the associated AOCI capital account, the related DTA resulting from the unrealized gain or loss on the AFS securities, and MSR assets are all unique to U.S. GAAP accounting. The interaction between Basel III and international accounting standards does not pose any of these three problems to bank regulatory capital in most other countries. Since most voting members of the Basel committee are from foreign countries, these problems do not affect their banks. At best, they are unaware of the capital volatility problem Basel III generates for banks in the U.S. At worst, they are aware of the problems this set of rules pose for U.S. banks, but not for their own banks.

The practical implication of this present state of disparate accounting treatment among countries is that the negative aspects of this provision of Basel III can be eliminated when a foreign bank acquires a U.S. bank and moves the bond portfolio of the acquired bank to the foreign parent company. If implemented as proposed, when interest rates rise, capital would fall precipitously at many U.S. banking organizations and U.S. banks would be faced with the choice of a) issuing expensive dilutive capital which will permanently and materially damage shareholder value, or b) selling to a foreign bank with much less damage to shareholder value. That foreign bank will be able to re-value the liabilities at closing pursuant to FAS 141R and instantly fix the capital shortfall at no cost (i.e. no need to issue new capital) and move the securities portfolio to the corporate parent to prevent the problem from recurring in the future, all at no economic cost to that foreign buyer. This effectively would put those U.S. banks which are small enough to be acquired, and large enough to matter to a foreign buyer, up for sale at discounted prices. We do not see this as a desirable public policy outcome.

Foreign owned banks with U.S. subsidiaries (with whom we directly compete in the markets we serve) will not need to hold any incremental capital cushion for this risk or

need to issue capital to cover this substantial volatility if they move their securities portfolio offshore to the foreign parent. The loan and deposit pricing advantage generated by such a capital disparity would give foreign owned banks a substantial and permanent competitive advantage over domestic banks. We do not view this as a desirable public policy outcome either.

#### **Loss absorbency of capital**

We acknowledge that a goal of regulatory capital is that it should be durable and loss absorbing. We will show that implementing the NPRs as proposed would create a worse outcome for the FDIC fund in a systemic-wide economic downturn or crisis as far as loss absorbency of capital is concerned.

To address the question of loss absorbency, one has to focus on the fact that the MTM of the entire balance sheet is far more important than the MTM of one portion of one side of the two sided balance sheet. If the securities portfolio gains \$1, but the deposit portfolio loses \$3 (both due to a decline in interest rates) it is the net \$2 loss that affects the loss absorbency of capital, not the \$1 gain. Fundamental to how a bank operates is sound asset-liability management, requiring that fixed rate assets be funded by fixed rate liabilities in the aggregate within reasonable tolerances. Even in cases where there is an interest rate risk position taken by a bank, that position is small relative to the total size of the securities portfolio. The best policy outcome is one which allows a balanced interest rate risk profile to exist so that the net MTM on the entire balance sheet can be minimized. This is better for the FDIC with respect to the few banks which fail, and necessary for the vast majority of banks which survive and support our economy.

#### **If these NPRs are implemented as proposed,**

- Banks will tend to shorten the duration of the bond portfolio to minimize the volatility of regulatory capital.
- This shortening of duration will make banks operate in a materially asset sensitive position as described earlier in this letter.
- In an economic downturn, interest rates will typically fall.
- When rates fall, an asset sensitive bank loses more value on the liabilities than it gains in assets, essentially ensuring that the loss to the FDIC fund will be as great as possible in liquidation events, and greater than if the bank had operated with a balanced rate risk position.

**If these flaws in Basel III and the NPRs are corrected,** prudent asset-liability management decisions will still be allowed. The changes in the value of the balance sheet resulting from changes in interest rates will be limited in total. Interest rate risk driven changes in the value of the bond portfolio will be roughly offset by interest rate driven changes in the value of the deposits and other liabilities.

If this aspect of the NPRs were to be implemented on the basis that a failing bank might not practice materially sound asset-liability management, that would push every bank in the country toward an unsound asset-liability management position, including that failing bank, by incenting an asset sensitive position - the very position that would be most

damaging for the FDIC fund, and the most damaging for the rest of the banking system's ability to rebuild capital through earnings during an economic downturn.

### **Deferred Tax Asset impact**

We understand the rationale for limiting net DTAs from regulatory capital, as they become impaired in situations of extreme stress. However, including the tax effect of a change in market value of only one portion of the balance sheet (i.e. the securities portfolio) in the DTA is without merit, and is a key contributor to the systemic risk issue.

The crux of this letter is that changes in the value of the securities portfolio due to market interest rate changes should not be subtracted from (or added to) capital because there is a fixed-rate or stable-rate funding source that is not being recognized. The same argument is true for the DTA generated by the tax effect of the mark-to-market on that same securities portfolio. There is a fixed-rate or stable-rate liability that would have an offsetting Deferred Tax Liability (DTL) that is not being recognized. As there is no practical mechanism to determine a mark-to-market for a core deposit account, both the Asset (i.e. securities portfolio) MTM and the Liability MTM need to be left out of both the DTA and AOCI. The solution must work for all points in the rate cycle, not just points where the securities portfolio MTM generates a temporary DTL.

### **MSR impact**

We, like many banks, hedge the MSR asset because it is sensitive to market interest rates. If interest rates increase, the MSR asset increases in value and the hedge generates an offsetting loss, leaving capital and earnings roughly unchanged. However, under this NPR, the MSR gain would be subtracted a second time from regulatory capital (the first time being from the hedge loss), leaving regulatory capital lower, solely because interest rates increased.

Given that the DTA resulting from loan loss reserves and other items are likely to use nearly 10% of the 15% combination limit for most regional and community banks, this NPR effectively leaves only the remaining 5% for MSR Assets. Many of the very large and very complex banks may have other lines of business which generate deferred tax liabilities which net against the deferred tax asset of the loan loss reserve, thereby allowing those complex banking organizations to have MSR assets of up to 10% of T1CE since for them the combination limit of 15% is not the limiting factor. We recommend moving the combination limit to 20% for non-internationally active banks to allow a reasonable level of participation in the MSR business for banks of all sizes, allowing us to compete on equal footing. This should not pose a problem for international Basel III compliance.

### **Capital alignment with risk**

The following table highlights the misalignment of capital and risk of this aspect of Basel III and the NPR by making three simple comparisons. All three positions have the same level of interest rate risk. The T-Bill plus Swap position has more credit risk than the 5 year U.S. T-Note due to the counterparty credit exposure on the derivative. The commercial loan has more credit risk than the other two positions.

		Basel III Capital if rates are unchanged	Basel III Capital if rates move up 400bp	Comparative Overall Risk Level
1	5 year fixed rate US Treasury Security	3%	Near 20%	Lowest
2	90 day US T-bill plus 5 year Receive Fixed cash flow hedge interest rate swap	3%	Near 4%	Medium
3	5 year fixed rate commercial loan	8.5%	8.5%	Highest

When capital and risk are severely misaligned, as they are in the above example, inefficient or bad outcomes are inevitable. U.S. Treasury and other bonds would be shunned, in favor of swaps. Pricing decisions may reflect regulatory capital levels, instead of risk levels.

It is important to note that the illogical result highlighted in the above table only occurs when applying Basel III to banks following U.S. GAAP. Banks following international accounting standards would have a logical alignment of capital and risk for the same Basel III capital rules because their accounting for securities and the DTA relating to securities is different. We do not believe the Basel committee would consider the above outcome to be desirable for the banks in their home countries.

#### **Recommendation to address capital volatility**

We strongly support the alternative approach described in the NPR involving an AOCI-exclusion for a defined universe of high quality investment securities. The exclusion must apply to both the after-tax unrealized gain or loss in AOCI, as well as the Deferred Tax Asset resulting from the tax-effect of the same unrealized gain or loss. This would mean excluding the amount of DTA or DTL generated by the AFS securities portfolio from both the 10% individual limit on DTA and the 15% combination limit.

There is more than one effective approach available to define the universe of high quality securities which would be excluded from AOCI and the DTA limit. We strongly recommend that, at a minimum, U.S. Treasury securities, U.S. Agency securities, GSE securities (including mortgage related and debentures), and zero risk weight sovereign securities be included. We recommend that all securities eligible for the LCR numerator be included. We also recommend that high quality general obligation municipal securities which qualify for 20% risk weight, or which meet a similar credit quality definition, be included.

While basic interest-rate-risk management objectives can be successfully attained with or without the inclusion of municipal securities in the AOCI/DTA exclusion, both risk management at banks and financing costs for municipalities are supported with their inclusion in the defined universe. If left out, a portion of municipal financing would shift from a security form to a loan form, and both pricing and the liquidity of the municipal securities market would suffer. The liquidity risk profile of banks would decline slightly versus present levels as liquid municipal securities would be replaced by relatively illiquid municipal loans. The bulk of the negative consequences would be felt by the municipal issuers, not by banks.

#### Consistency with paragraphs 71 and 72 of Basel III

We believe this solution is consistent with the intent of Basel III. Paragraphs 71 and 72 of Basel III demonstrate an understanding by the Basel Committee that:

- Hedging and interest rate risk management actions have two sides.
- The Mark-To-Market through capital of one side and not the other would generate artificial volatility in common equity.
- Artificial volatility in common equity is undesirable and should be removed for prudential reasons.

At banks of all sizes in the U.S., fixed rate investment securities are performing essentially the same interest rate risk / hedging function with respect to the fixed and stable rate deposit portfolio or other liabilities. The securities portfolio unrealized gain or loss should be “derecognized” in the same way as the cash-flow hedge is derecognized per paragraph 71 of Basel III. Not doing so generates the same artificial volatility in common equity. Because we are talking about the same issue, and because Dodd-Frank has encouraged U.S. banking regulators to limit the amount of derivative interconnectedness, the only way to give U.S. banks access to the same protections that paragraph 71 and 72 give to foreign banks, is to give U.S. banks the ability to derecognize the gain or loss on at least a defined universe of high quality investment securities.

The downside of the above recommendation is that the remaining securities portfolio would contribute to the pro-cyclicality of any future stress scenario. While it would not be consistent with Basel III, we believe that a better solution to the above is to exclude the AOCI and the DTA associated with the entire AFS securities portfolio from any capital constraints.

#### Cash flow hedge de-recognition of AOCI and questions 28-30

We see this applying to variable rate assets which are hedged with a receive fixed, pay floating interest rate swap, and to variable rate liabilities which are hedged with a pay fixed, receive floating swap. The situation of a receive fixed swap hedging the cash flows of a variable rate asset is the much more common application for banks operating with a “normal” commercial banking business model. This type of receive-fixed hedge accomplishes a similar interest rate risk management objective as the purchase of fixed rate investment securities. As such, we support the de-recognition of unrealized gains and losses from AOCI for these cash flow hedges as proposed in the NPR and as described in Basel III. In fact, if unrealized gains and losses on AFS investment

securities are to impact (i.e. be recognized in) regulatory capital, the de-recognition of unrealized gains and losses for receive-fixed cash flow hedges will become extremely important.

**The following Comments relate to issues other than capital volatility:**

**Risk weights for consumer mortgages**

The risk weights for consumer mortgage exposures appear excessive relative to the risk in prudently underwritten mortgages within the delineated categories. It appears from the RWA levels proposed that the risk weights may be unduly influenced by the worst underwritten paper from the worst performing origination channels of the worst originators. While that data is easily observable in the securitization markets and from the FDIC's records, that may not represent the risk of the existing stock of consumer mortgage exposures. Applying excessive risk weights to consumer mortgage will unnecessarily hamper the housing recovery. We recommend that mortgage risk weights be re-assessed to align better with the risk content of the loans. If high risk weights are being used to cover the risk of high concentrations in mortgages by certain banks, we recommend addressing the concentration issue directly.

Also important is the unfortunate consequence of category 1 first lien mortgage risk weights being tainted by the presence of a category 2 second lien home equity line. We fully understand the desire of policy makers to prevent banks from having the ability to arbitrage the capital rules by writing 80% LTV first lien loans with a "piggyback" second lien for an incremental 20% totaling 100% CLTV and accomplishing a lower all-in capital requirement than if a 100% LTV first lien loan had been written. However, we hope policy makers understand that a bank with a 80% LTV first lien mortgage customer who would like a home equity loan two years after closing his 80%LTV first lien loan would not want to tell that franchise customer that because of federally mandated regulatory capital rules, they can get their loan at any competitor for half price because their primary bank would need to hold effectively a 600% risk weight on the home equity loan but the competitors would need only a 200% risk weight capital assessment to be covered. This aspect of the NPR is anti-competitive and harms consumers.

The following would solve both problems. If the "second-lien-taints-the-RWA-of-the-first-lien" treatment applies only to first and second lien loans which are made contemporaneously or within a short time of each other. This solution would eliminate banks' ability to arbitrage the capital rules, while at the same time allowing banks to compete on equal footing for second lien mortgages made subsequently. We believe that there is considerable industry evidence to support the proposition that 100% CLTV achieved with an 80% first lien and a second lien home equity line of credit closed more than a year after the first lien has a much better long term credit risk profile than either a 100% LTV first lien or an 80/20 piggyback where the 100% CLTV exists at initial closing.

**Mortgage Insurance**

The NPRs allow for no recognition of mortgage insurance in capital assessments. This could have the effect of substantially reducing or eliminating the usage of mortgage insurance for loans retained in the on-balance-sheet portfolios of banks. If the revenue on the mortgage loans in question must “pay for” the ROE on a full allocation of bank capital, it could not also “pay for” the ROE on a full allocation of capital of the mortgage insurer to cover the same risk twice. We consider the risk spreading function of mortgage insurers to be of value, both for managing geographic concentration risk as well as mortgage sector exposure. If the Federal Reserve were to issue regulatory capital standards as well as capital stress test standards for mortgage insurers, that would enable this fairly small population of mortgage insurance firms to demonstrate that their capital meets the same level of adequacy as banks. Those mortgage insurance firms passing the regulatory standards should be given appropriate credit in bank regulatory capital.

### **Transition**

The NPR proposes a transition scheme which involves considerable complexity and a lengthy transition schedule. It appears that the goals are to minimize the adverse impact to lending capacity and to prevent any “backsliding” on the capital treatment of any individual subcomponent of any capital metric. We are concerned that this complex and lengthy transition schedule will result in circumstances where capital ratios will be (a) difficult to compare among banks, (b) impossible to compare between years for a given bank, and (c) difficult to calculate, audit, articulate in clear internal policies. It will be very difficult for depositors and investors to understand and compare capital adequacy. Specifically, it will be nearly impossible for investors, depositors and counterparties to bifurcate the year-to-year change in capital ratios into the change due to actual changes in real capital adequacy, and changes due to Basel III transition. If capital ratios lose their transparency from 2013 through 2019, we do not think that is good for anyone involved. We recommend a single-date all-at-once transition on the soonest date possible that will not result in a contraction in aggregate U.S. lending capacity. If a transition table for trust preferred is still necessary, that could be easily understood by the financial markets. This simpler approach would provide much greater transparency for capital adequacy trends of all banks to all market participants.

### **Subsidiary Bank Level Subordinated Debt and Minority Interest Exclusion**

The NPR appears to “haircut” the Tier 2 capital content of bank-level subordinated debt when determining capital ratios for the consolidated banking organization. We can see the logic of disallowing a portion of the consolidated Tier 2 content for those larger organizations with multiple subsidiaries of substance, and those with multiple banking subsidiaries in particular. However, for those banking organizations with one banking subsidiary and no other significant subsidiaries, we do not see the systemic benefit of a very strong incentive for issuing company level subordinated debt, and a very strong disincentive for issuing bank level subordinated debt. When the holding company issues the subordinated debt, the holding company liquidity risk profile becomes a real issue, both from debt service perspective, and more importantly from a maturity and refinance perspective. In the case of a simple, single-bank organization, as is often the case with regional and community banks, the subordinated debt protects depositors at least as well

at the bank level as it does at the holding company. Overall bank stability and banking system stability are arguably better with subordinated debt at the subsidiary bank level.

One solution would be to eliminate the minority interest exclusion on bank-level subordinated debt for banking organizations with a single banking subsidiary and no more than 10% of its risk-weighted assets in non-bank subsidiaries of the holding company (excluding, of course, direct or indirect subsidiaries of the bank subsidiary). A second solution, which would avoid the small cliff effect of the above, would be to multiply the minority interest exclusion factor applied to the subordinate debt of a banking subsidiary by the quantity (1 minus the square (or cube) of the percentage of consolidated RWA represented by the banking subsidiary which issued the subordinated debt.) This would seem to address the issue of trapped capital in a remote subsidiary inaccessible by the primary banking organization without penalizing community and regional banks with simple operating structures.

#### **Subordinated Debt and Tier 2 Qualification**

It is our belief that the Agencies do not seek to generate widespread disqualification of Tier 2 capital content of existing subordinated debt. However, if provisions #5 and #10 relating to Tier 2 capital requirements were to be interpreted very narrowly and applied strictly to the agreement within the four corners of the prospectuses of the existing stock of securities, it is not clear that there would not be a material change in the aggregate amount of qualifying Tier 2 capital stock. Any clarification that could be provided in the final rule on this issue would be helpful.

#### **Basel III leverage ratio (Question #2)**

We support the scope of application of the Basel III leverage ratio as proposed in the NPR.

#### **Clarification of Well Capitalized and consolidated company capital thresholds**

It would be beneficial if the final rule would provide additional clarity on the different capital standards applied to banks and consolidated banking organizations, and how the terminology applies. While considerable detail was provided in the NPRs, this is a large enough shift in approach that additional clarity would be helpful. Does the concept of Well Capitalized still apply to consolidated banking organizations, or does that term only apply to banks? Is it correct that capital conservation buffers do not apply to banks, only to consolidated banking organizations? Is there a defined term that means being above the capital minimums plus all the applicable buffers, (in the same way that Well Capitalized works, but applies to consolidated banking organizations)?

#### **Gross-up method and SSFA for securitizations**

The gross-up method and the SSFA in the standardized proposal are a considerable improvement to the securitization approach in the originally proposed market risk rule NPR. While there are incremental improvements that could be made, the extremely procyclical elements have largely been removed and we hope that remains so in the final rule. The establishment of a floor of zero for the factor "L" is a key part of that solution.

**Credit enhancing representations and warrants**

Please provide additional clarity on the credit enhancing representation and warranty provisions for sold loans. Please address what qualifies as a representation and warranty and how that definition interacts with sale conventions with FHLMC, FNMA, and GNMA. Would a loan with a 35% risk weight and a loan with a 200% risk weight both have a 100% risk weight if sold with a credit enhancing representation or warranty? Would the risk weight fall to zero after the expiration of the representation or warranty on a sold loan?

**Restrictions on incentive compensation**

Skilled managers are mobile and boards of directors need the ability to retain talent in banks under stress. Applying the incentive compensation restrictions to the five executives whose compensation is disclosed in the proxy statement of publicly traded institutions, or their equivalents at privately held institutions, seems to optimally satisfy public policy objectives.

**Risk weights for past due exposures (Question #9)**

This proposal, if applied to a commercial loan secured by real assets, would appear to require 100% risk weight when the loan is not past due, 150% when it is 90 days or more past due or not accruing, and then 100% after the loan is foreclosed and the assets are held in OREO. We believe the time when the carrying value of a loan is charged down to the amount expected to be recovered is the better trigger to reduce the risk-weight from 150% to 100%. We recommend this change be made to the final rule.

Please let us know if we can clarify any of the above comments.

Sincerely,



Martin Grunst, CFA  
SVP and Treasurer