Capital One Financial Corporation
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McLean, VA 22102

May 29, 2012

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
Comments@FDIC.gov

Re: Assessments, Large Bank Pricing Definition Revisions
Notice of Proposed Rulemaking
(RIN 3064-AD92)

Dear Mr. Feldman:

Capital One Financial Corporation[1] ("Capital One") is pleased to submit comments to the Federal Deposit Insurance Corporation ("FDIC") on its proposed large bank pricing definition revisions.[2]

In February 2011, the FDIC adopted a final rule ("Final Rule") establishing a new methodology for determining assessment rates for large and highly complex insured depository institutions ("IDIs").[3] The Final Rule defined leveraged loans and subprime loans, among other assets, to identify concentrations in higher-risk assets for purposes of determining an IDI's deposit insurance assessment rate under the risk-based assessment system.[4] The proposed revisions fine-tune the definitions of leveraged loans and subprime loans, now termed "higher risk C&I loans and securities" and "higher-risk consumer loans and securities" respectively.[5]

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[1] Capital One Financial Corporation (www.capitalone.com) is a financial holding company whose subsidiaries, which include Capital One, N.A. and Capital One Bank (USA), N. A., had $216.5 billion in deposits and $294.5 billion in total assets outstanding as of March 30, 2012. Headquartered in McLean, Virginia, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients. Capital One, N.A. has approximately 1,000 branch locations primarily in New York, New Jersey, Texas, Louisiana, Maryland, Virginia and the District of Columbia. A Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol "COF" and is included in the S&P 100 index.
[2] 77 Fed. Reg 18109 (March 27, 2012).
[3] 76 Fed. Reg 10672 (February 25, 2011).
[4] *Id.* at 10723.
[5] 77 Fed. Reg. at 18110.

Capital One appreciates the FDIC proposing these revisions in response to the feedback from the American Bankers Association ("ABA") and others. The changes make the rule more manageable, but concerns remain. To that point, we have participated in and support the positions expressed in the comment letter filed by the ABA and other industry groups in response to these proposed revisions.[6] That letter raises important, industry-wide concerns about the revised rule. Our comments are intended to supplement the comments submitted by the ABA, with a focus on the 20% probability of default (PD) threshold for higher-risk consumer loans and securities and the definition of "refinance."

The Federal Deposit Insurance Act requires that the deposit insurance assessment system be risk-based, defined as one based on an institution's probability of causing a loss to the Deposit Insurance Fund.[7] Specifically with respect to the concentration measure that is the subject of the proposal, "[t]he high-risk concentration ratio captures the risk associated with concentrated lending in high-risk areas that directly contributed to the failure of a number of institutions during the recent economic downturn."[8]

To more accurately capture the magnitude of risk, the definition of higher-risk consumer loans should be tailored for different asset types, taking into account factors beyond PD.

The FDIC requests comments on whether the proposed PD level of 20 percent is appropriate to identify higher-risk consumer loans[9] and whether other risk measures, besides PD, should be considered in the definition.[10] We believe that it would be more appropriate to tailor the PD level to different asset classes, taking into account factors other than PD, or to consider other risk measures in the definition.

The proposed revisions define higher-risk consumer loans as:

> *All consumer loans* where, as of origination, or, if the loan has been refinanced, as of refinance, the probability of default (PD) within two years (the two-year PD) was greater than 20 percent, excluding those consumer loans that meet the definition of nontraditional mortgage loan....[11]

The proposed definition of higher-risk consumer loans uses a uniform PD threshold for all types of consumer assets, including mortgages, auto loans, and credit cards. This blunt PD approach, however, ignores the fact that among different loan types, higher loss is not synonymous with higher risk.

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[6] Comment letter to Robert E. Feldman from the ABA, American Securitization Forum, Financial Services Roundtable, Loan Syndications and Trading Association, and The Clearing House (May 29, 2012).
[7] 12 U.S.C. § 1817(b)(1) (2006).
[8] 76 Fed. Reg. at 10692-93.
[9] 77 Fed. Reg. at 18118, question 1.g.
[10] *Id.*, question 1.e.
[11] 77 Fed. Reg. at 18121 (emphasis added).

There are important negative consequences of using a definition that is not properly tailored to the risk inherent in each asset class. If large segments of loans are misclassified as higher-risk and are costly for large banks to hold, banks must offset the additional cost of these loans, presumably through higher prices or decreased availability of these types of credit. Simply put, while the FDIC's proposed approach may work as a blunt estimate for industry-wide risk or changes in risk over time, it is inappropriate to make such an approach the basis for an individual institution's insurance premium.

Default rates vary by product type, and higher default rate products are not synonymous with higher risk products or higher institutional risk. The PD threshold should be set at different points for different asset classes or additional risk measures should be used.

As noted above, the proposed definition of high-risk consumer loans uses a uniform PD threshold for all types of consumer assets. We believe, however, that using a uniform threshold does not adequately measure institutional risk, given the differences between asset types. Different loan types have differing levels of average historical default rates and thus expected PDs, but a default rate difference alone does not indicate that a product is inherently more or less risky. For example, lenders expect unsecured loans like credit cards to have higher default rates than secured loans like mortgages, which the unsecured lender mitigates through higher interest rates and/or other pricing.

Institutional risk stems not from higher absolute default rates, but from the failure to price for volatility of those default rates. The greater the degree of certainty a lender possesses regarding the loss rate of a particular asset type, the lesser the "net risk" incurred by that lender, even where absolute loss rates are high. This outcome stems from that lender's enhanced ability to price the asset appropriately for its loss rate. During the Great Recession, for example, although credit card default rates were higher than some other asset types, credit cards as an asset class tended to worsen less than other asset types.[12] In contrast, although mortgage default rates were lower than credit cards on an absolute level, mortgages created significant and unexpected losses and institutional and systemic risk, owing to very volatile default rates that were not appropriately priced into the mortgages. The FDIC's proposed definition would charge lower premiums with respect to asset types solely because of lower mean default rates, without regard for whether the assets actually pose lower risk to the institution.

Because the magnitude of risk varies by type of asset, we propose tailoring the PD threshold to the type of asset (at the very least tailoring the PD threshold for secured and unsecured loans, given the significant differences between those asset types) or

[12] During the Great Recession, credit card loss rates increased 158% relative to 2006 levels, while residential and commercial real estate loss rates increased over 2000% and 4000%, respectively. Charge-Off and Delinquency Rates on Loans and Leases at Commercial Banks, Board of Governors of the Federal Reserve System (Feb. 17, 2012), http://www.federalreserve.gov/releases/chargeoff/chgallsa.htm. Indeed, this phenomenon is not limited to the Great Recession. Over the past eighty quarters, loss rates have changed more than 25% quarter-over-quarter 21 times for residential real estate loans and 35 times for commercial real estate loans, but only 15 times for credit cards. *Id.*

considering other risk measures in the definition.[13] We recognize that the FDIC must strike a balance between rigor and accuracy and efficiency. It appears, however, that the FDIC has access to a robust and detailed data set, and we believe it can be used to take into account in some manner the concerns above. This could include consideration of historic default rates, yields, resilience to stress, and volatility of losses by asset types. These factors could be used to adjust the PD level, perhaps significantly for some asset types, or as separate risk measures for consideration in the definition.

To appropriately and efficiently estimate institutional risk, the definition of refinance should exclude interest rate changes for credit cards.

As mentioned above, the proposed definition for higher-risk consumer loans includes loans where "as of refinance, the [PD] within two years (the two-year PD) was greater than 20 percent."[14] The proposal defines a refinance to include "an extension of new credit or additional funds on an existing loan or the replacement of an existing loan by a new or modified obligation," including an increase or decrease in the interest rate.[15] The FDIC requests comments on whether the definition of refinance is appropriate and, more broadly, whether the proposed definitions are clear.[16]

As drafted, we have concerns that the definition could be read to deem interest rate changes for credit card accounts as "refinances", and seek clarity that the FDIC does not intend to apply the rule in this manner. As described more fully below, credit card interest rates change very frequently, particularly since interest rates are typically variable and thus change as indexes move. Furthermore, credit card interest rate changes do not involve the replacement of an existing loan by a new or modified obligation, and the portfolio risk implications associated with such common rate changes are negligible. Thus, we believe that the definition of refinance should exclude interest rate changes for credit cards.

As the FDIC is aware, interest rate changes for credit card accounts, whether up or down, are routine. Changes occur for many reasons, including: adjustments of variable interest rates as the underlying index fluctuates, expiration of introductory rates to previously disclosed long-term rates, special rates for balance transfer offers or to increase customer

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[13] We believe that this approach is similar in concept to how the FDIC treats "nontraditional mortgages" under the proposed rule, seemingly acknowledging that different asset types pose different levels of risk. 77 Fed. Reg. at 18119.

[14] *Id.* at 18121.

[15] *Id.* at 18124. The proposed definition revisions define a refinance to include

> an extension of new credit or additional funds on an existing loan or the replacement of an existing loan by a new or modified obligation. A refinance includes the consolidation of multiple existing obligations, disbursement of additional funds to the borrower, an increase or decrease in the interest rate.... Additional funds include a material disbursement of additional funds or, with respect to a line of credit, a material increase in the amount of the line of credit....[A] material increase in the amount of the line of credit is defined as a 10 percent or greater increase in the quarter-end line of credit limit.

[16] *Id.* at 18118, question 1.h.

loyalty, rate changes mandated by the Credit CARD Act,[17] rate increases if certain contractual requirements are violated, and rate decreases to retain customers.

Such changes would not alone constitute an extension of new credit or the replacement of an existing loan by a new or modified obligation, as credit cards are non-maturing credit vehicles that are not actually "refinanced." In addition, interest rate changes may be made to a credit card account multiple times in a given calendar year and are in many cases not conducted in connection with an underwriting review. This is in contrast to other loan types, where many types of pricing changes are infrequent and accompanied by partial or full re-underwriting and a new or modified loan obligation. Finally, many of these changes are contractual in nature or required by law, and are not at the lender's discretion.

The FDIC's proposed definition, if applied to credit card interest rate changes, would impose burden on credit card management that far outweigh any value in institutional risk estimation, which is likely to be negligible at best. We thus recommend that the FDIC exclude interest rate changes for credit cards from the definition of refinance.

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Capital One appreciates the opportunity to comment on the FDIC's proposed large bank assessment definition revisions. We would welcome the opportunity to further discuss our comments with you. If you would like to discuss our comments, please call me at 703-720-1857.

Sincerely,

Ram Narayan
Managing Vice President, Credit Risk

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[17] 12 C.F.R. § 1026.59 (2012) (implementing the CARD Act requirement). The general rule is:

(1) Evaluation of increase rate. If a card issuer increases an annual percentage rate that applies to a credit card account under an open-end (not home-secured) consumer credit plan, based on the credit risk of the consumer, market conditions, or other factors, or increased such rate on or after January 1, 2009, and 45 days' advance notice of the rate increase is required pursuant to section 226.9(c)(2) or (g), the card issuer must:

(i) Evaluate the factors described in paragraph (d) of this section; and

(ii) Based on its review of such factors, reduce the annual percentage rate applicable to the consumer's account, as appropriate.