American Bankers Association
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The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, D.C. 20219

The Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

The Honorable Janet L. Yellen
Chair
Federal Reserve Board
Eccles Board Building
20th and C Street, N.W.
Washington, D.C. 20219

Re: Basel Standardized Proposal and Improvements to U.S. Process for International Standards

Dear Comptroller Curry, Chairman Gruenberg, and Chair Yellen:

On December 10, 2015, the Basel Committee issued a second consultative document titled "Revisions to the Standardised Approach for credit risk" (Proposed Revised Standardized Approach). Previously the Committee had issued a related consultative document titled "Capital floors: the design of a framework based on standardised approaches." The December document would revise the risk-based capital denominator. The earlier would establish the Revised Standardized Approaches as a risk-based capital floor for banking organizations globally.

At the same time that the Proposed Revised Standardized Approaches was released, the U.S. banking agencies (Banking Agencies) issued a press release stating—

> These proposed revisions would apply primarily to large, internationally active banking organizations and not to community banking organizations.[1]

This signal from the Banking Agencies regarding the scope of applicability in the United States of the Basel Committee's *ongoing* work on capital rules served to lessen the worries of many community banks that they may face yet another series of major changes to capital rules while

[1] Press release is available at http://www.federalreserve.gov/newsevents/press/bcreg/20151210b.htm.

the most recent reforms are still being implemented. However, particularly for larger institutions, uncertainty about U.S. implementation constrains the ability to provide informed comments to the Basel Committee. The American Bankers Association (ABA)[2] continues to believe that the development of international standards for regulatory capital rules would be better crafted and better matched to the U.S. economy if the process for developing international standards were more robust and transparent, particularly with regard to early engagement with the public.[3]

The potential adoption by the Banking Agencies of the proposed standards for larger banks has raised a probably unintended but equally unwise and unnecessary prospect: banking organizations subject to the Advanced Approaches regulatory capital standard[4] having *two* risk-based capital floors. There is little merit in that outcome, and in fact it would likely distract attention from a more useful focus on the capital measurements that yield the most supervisory and management value.

Wholesale adoption of the Proposed Revised Standardized Approach as a second floor would create significant implementation and compliance burdens, while also further complicating the already excessively complex process of managing to numerous different capital ratios. Moreover, a second risk-based capital floor would unlikely be of use to the investor community and provide little added value to banks' safety and soundness or systemic stability. As a result, ABA opposes wholesale adoption of the Proposed Revised Standardized Approaches and the establishment of another risk-based capital floor.

That is not to say that there is no value to be garnered from the initiative. ABA believes that some of the proposed methodologies are improvements to the existing methodologies in the U.S. standardized approaches (Generally Applicable Capital Rules). As a result, we encourage the Banking Agencies to propose the listed methodologies *as options* under the Generally Applicable Capital Rules for all banks.

For example we believe the following elements of the Proposed Revised Standardized Approaches to be improvements over the current capital standards:

1) Revised methodology for securities lending transactions – The "collateral haircuts" methodology for securities lending transactions would be made more risk sensitive by accounting for portfolio diversification and product correlation.

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[2] The American Bankers Association is the voice of the nation's $16 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $12 trillion in deposits and extend more than $8 trillion in loans.
[3] Although this letter specifically focuses on the process for developing international *capital* standards, the same procedural improvements we suggest are applicable to other global standard setting initiatives for financial institutions (e.g. liquidity, interest rate risk).
[4] The Advanced Approaches capital rules are mandatory for banking organizations with $250 billion or more in assets or $10 billion or more in foreign exposure.

2) Revised methodology for exposures to securities firms – The treatment of exposures to securities firms would be made equivalent to the treatment of exposures to banks provided that the securities firms are subject to prudential standards and a level of supervision equivalent to that applied to banks.
3) Revised methodology for corporate exposures – The treatment of corporate exposures would be more risk sensitive, incorporating assessments of creditworthiness rather than applying a standard 100% risk-weight; and,
4) Retail exposures – Permitting a 75% risk-weighting for retail exposures.

I. The Banking Agencies Should Adopt Procedures for Greater Public Involvement in Setting International Standards

In response to the adoption of the Basel III standards in the United States, many smaller banking organizations were surprised and frustrated by the manner of the United States' participation in the Basel Committee's deliberations. These reactions stemmed from the problem that even though the Basel standards were publicly held out to be intended for large, internationally active banks, leading to little public attention by other financial firms, the Banking Agencies applied the resulting global plan beyond that scope. As a consequence, when the Basel III regulations were proposed, they touched off a high level of public and congressional controversy, something that we believe could have been avoided and that should be avoided in connection with any future development of international financial services standards. ABA has encouraged the Banking Agencies to adopt a public process that brings greater transparency and accountability to U.S. participation in the development of international regulatory standards, increasing the likelihood for better understanding and national consensus on standards.[5]

Timely public discussion of the concepts involved in the development of international standards would improve the possibility for national consensus and provide for better-informed regulatory representation in the development of standards. We believe that both accountability and transparency would be enhanced by reliance on an existing process within the structure of the Administrative Procedure Act, namely that the Banking Agencies prior to engaging in an international standard development exercise, publish via an Advance Notice of Proposed Rulemaking (ANPR) the following items, among other pertinent matters:

- The issues or problems to be addressed;
- The various options likely to be considered;

[5] See ABA letter dated November 12, 2013, in response to FDIC Basel III Interim Final Rule. Available at: http://www.aba.com/Advocacy/commentletters/Documents/11-12-13CommentLettertoFDICreBaselIII.pdf. Also, ABA letter to House Financial Services Committee dated March 1, 2016. Available at http://www.aba.com/Advocacy/LetterstoCongress/Documents/ABAletterHIsubcommfeb2016.pdf.

- The nature of the standards being considered for application in the U.S. or affecting U.S. persons or businesses;
- What authority will be relied upon to implement such proposed standard; and,
- The anticipated impact of the various options on U.S. persons, businesses, and the economy in general.

We recognize that, for example, that the Basel Committee does issue proposals for some degree of comment. Often, these come relatively late in the process, after the basic framework has been substantially developed, options have been narrowed, and a strong degree of international commitment to a new regulatory regime has been reached by the regulatory participants. Moreover, because the rules are ostensibly intended for institutions that operate at the *global level*, the vast majority of U.S. banks, and the American public, are generally unaware of the committee's proposals and do not monitor or participate in the international comment process. Neither does it appear that Congress is brought actively into the process before the Banking Agencies take up implementation of the international agreement.

As the Banking Agencies prepare to discuss developing standards in Basel, they should have a much clearer understanding of to whom and how the standard could apply domestically, and that understanding should be shared with affected banks and their customers. Use of an ANPR would alert the public that the Basel Committee is considering standards that could apply to a significant portion of the banking industry and to banking customers, offering the public the critical opportunity to raise important issues publicly with both the Banking Agencies and the Basel Committee before nation-to-nation negotiations harden, allowing U.S. Banking Agencies to participate in discussions with a greater degree of information on how U.S. customers and institutions would be affected.

The Banking Agencies' press release on December 10, 2015, was an important step in recognizing the value of greater transparency. At a relatively early stage of discussion, it identified a standard that is actively being considered by the Banking Agencies and in general terms provided the scope of potential application in the United States. While a significant improvement, the press release provided very limited information, and many questions still remain. ABA has been approached by mid-size, regional, and Advanced Approaches opt-in banks[6] with questions about the potential scope of application in the United States. Moreover, larger banks are struggling with how the Revised Standardized Approach could apply while maintaining the generally applicable standardized approach for all banks, as required by the Collins Amendment to the Dodd-Frank Act. Because of this uncertainty, efforts to provide comments to the Basel Committee are constrained.

[6] All banking organizations may elect to use the Advanced Approaches regulatory capital standard. From the press release it is unclear if banks that have opted to use the Advanced Approaches would be considered internationally active.

In addition, the Banking Agencies should conduct empirical studies of the impact on the U.S. banking system, bank customers, and the economy that would result from the adoption of proposed international standards to be considered. While the Basel QIS process is informative, that process is limited to a few banking organizations and does not take into account U.S. specific laws that might alter how a standard is implemented in the United States. For example, the Proposed Revised Standardized Approach explains that the Basel Committee believes the existing credit conversion factors for unconditionally cancellable commitments (e.g. unused credit card lines) is inappropriate, and proposes a new CCF because, in part, "consumer protection laws…appear to constrain banks' ability to cancel such commitments." However, such considerations would not restrict U.S. banks' ability to cancel credit card lines, as applicable U.S. law does not prohibit a credit card issuer from reducing or canceling a customer's credit line without prior notice.[7] Therefore, one of the stated rationales for the proposed CCF increase would be wholly inapplicable for U.S. banks. In order to support U.S. rulemaking efforts, the empirical study could be conducted during an ANPR phase with the result made publically available. Public availability of the study would notify the public of the analyses underlying key elements of the Banking Agencies' determinations, as is required under the Administrative Procedure Act.[8]

Use of an ANPR, as well as any related study, would enhance the likelihood that the Banking Agencies are fully informed as they negotiate in the Basel Committee. Moreover, it would allow banks and the public to identify and comment on banking policy objectives and standards at a stage of the process where appropriate adjustments to the needs of the U.S. economy can be most easily made.

II. The Banking Agencies Should not Consider Wholesale Adoption of the Revised Standardized Approaches

The Banking Agencies should not consider the adoption of the Proposed Revised Standardized Approach as a second risk-based capital floor, because it would create costly and redundant systems with no additional safety and soundness benefit for U.S. banks. The press release issued by the Banking Agencies has raised the possibility of U.S. Advanced Approaches banking organizations being subject to *two* risk-based capital floors simultaneously. The first, which is applied as a result of provisions contained in the Dodd-Frank Act, has the current U.S. standardized approach (*i.e* the Generally Applicable Capital Rules) acting as a floor to the Advanced Approaches risk-based capital standard. The second could potentially be the Basel

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[7] In the event that a creditor takes an adverse action on an existing account, such as reducing or, in some cases canceling a credit line, the Equal Credit Opportunity Act and implementing regulation (commonly referred to as "Regulation B"), require that the creditor send written notice of the action to the applicant within 30 days after taking such action. However, applicable consumer law does not prohibit prudently managing risk through reducing or canceling open credit card lines.

[8] The Administrative Procedure Act requires the Agencies to "offer the rational connection between facts and judgment." *Motor Vehicle Mfrs. Ass'n of U.S., Inc.* v. *State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, at 31(1983).

Committee's Revised Standardized Approach.[9] In total, this would mean Advanced Approaches banking organizations in the United States could be forced to report and disclose as many as nine risk-based capital ratios, with several that produce disparate and inconsistent results (in addition to several leverage, or risk-blind, capital measurements).

The additional ratios would require banks to create redundant and costly systems for compliance with additional ratios that address the same risks as existing ratios. Adoption of a second risk-based capital floor would make internal capital management and allocation, along with the management of business activities, increasingly complex, detracting from rather than enhancing prudential management of the bank. This is a problem for regulators and regulated alike. Furthermore, it is highly unlikely that the investor community would find an additional capital floor to be a useful metric for risk, and indeed there is the very real prospect of substantial confusion and misapplication, undermining the effectiveness of market discipline.

Adoption of a second risk-based capital floor in the United States based on the Proposed Revised Standardized Approach is unnecessary considering the current Dodd-Frank Act risk-based capital floor, leverage rules, and capital planning and supervisory stress testing requirements. We also note that adoption is unnecessary from the perspective of the Basel process, because paragraph 26 of the Basel Committee's floor proposal permits in this instance significant and appropriate national discretion.

In light of the discretion afforded to individual jurisdictions, the Banking Agencies can and should consider the additional costs of a second risk-based capital floor together with the insignificant additional safety and soundness benefit of such a floor over the current U.S. regulatory capital framework. Having done so, it is likely that the case for wholesale adoption of the Proposed Revised Standardized Approach will be unconvincing.

III. Methodologies the U.S. Banking Agencies Should Consider Proposing in the United States as Options under the Generally Applicable Capital Rules

ABA believes, however, that some of the proposed methodologies in the Proposed Revised Standardized Approaches are improvements to the existing methodologies in the U.S. standardized approaches. As a result, we encourage the Banking Agencies to propose those methodologies listed below *as options* under the Generally Applicable Capital Rules for all banks.

[9] The Agencies' press release indicated that the Proposed Revised Standardized Approaches is not being considered for community banks. As a result, there is confusion about whether larger banking organizations would still be subject to the current, generally applicable, standardized approaches if the Revised Standardized Approaches is adopted domestically.

Revised Methodology for Securities Financing Transactions (SFTs).

The Generally Applicable Capital Rules use the risk-insensitive haircut-based "Comprehensive Approach" for the measurement of exposures to SFTs, including repurchase agreements, reverse repurchase agreements, securities lending and borrowing transactions, and eligible margin loans. Under this approach, exposures can be reduced by eligible financial collateral, however, banking organizations must decrease the value of the collateral received, and increase the value of the securities posted, by a series of pre-determined haircuts. These haircuts also apply to any differences in foreign currency on both sides of the same transaction.

This approach suffers from several shortcomings. First, the approach implicitly assumes that for every trade, each security posted as collateral increases in value while each security received as collateral decreases in value, and that the impact of foreign exchange movements is always negative. Second, this approach ignores the effect of portfolio diversification in the distribution of risk, assuming at all times that securities issuances will move in a perfectly correlated manner. Third, the approach provides for very limited opportunities to net transactions, which is only allowed at the level of the individual security. This results in an exposure measure that is highly risk-insensitive and multiples higher than the 'maximum possible loss' that a bank could incur.

The revised methodology for SFT proposed by the Basel Committee goes a long way towards addressing these concerns. This includes changes which permit the netting of loans and offsetting collateral by counterparty, the use of a factor to approximate correlation on a market-wide basis, and the use of a factor to approximate the impact of portfolio diversification. While the proposed methodology remains conservative, with exposure amounts that are 7x to 10x greater than exposure amounts using simple value-at-risk methodologies, these outcomes are a significant improvement over the prevailing "Comprehensive Approach" and therefore warrant inclusion as an option under the Generally Applicable Capital Rules.

Revised Treatment of Securities Firms.

The application of a 100% risk weight for exposures to broker-dealers and securities firms within the Generally Applicable Capital Rules is disproportionate relative to the risk weights for other prudentially regulated financial institutions. On a global basis, many regulators mandate stand-alone capital requirements for broker-dealers that are broadly equivalent to Basel standards; they also often impose other regulatory constraints, such as liquidity requirements and the segregation of client assets. Many broker-dealers are also subsidiaries of prudentially regulated bank holding companies. Given that the regulatory regimes for broker-dealers are similar to those for banking organizations, and because banking organizations' exposures to these broker-dealers will be subject to the financial institution deduction, these exposures should in fact be less risky.

The Proposed Revised Standardized Approach recognizes these safeguards and applies lower risk weights to securities firms, including broker-dealers consolidated into a banking holding company, that are "subject to prudential standards and a level of supervision equivalent to those applied to banks…"[10] These broker-dealers should not be penalized with a 100% risk weight. We see no discernible reasonable justification for this inconsistency, which could create competitive distortions in global financial markets. We therefore urge the Banking Agencies to align the risk weights for registered broker-dealers to those that apply to banking organizations and amend the Generally Applicable Capital Rules.

Revised Treatment of Corporate Exposures.

The Generally Applicable Capital Rules apply a flat risk-weight of 100% to all corporate exposures, regardless of the credit risk characteristics of the corporate entity. This blanket approach is in tension with other elements of U.S. banking regulation, in particular conditions applicable to national banks' investments that require an "investment grade" determination and other elements of the Standardized Approach that apply varied risk-weights within an exposure category based on the underlying features of exposure, such as preferential risk-weights that apply to first-lien residential mortgages in comparison to higher risk-weights that apply to other categories of residential and commercial real estate exposures.

By contrast, the Proposed Revised Standardized Approach would require U.S. banking organizations to apply different risk-weights to investment grade and non-investment grade corporate exposures. Applying lower risk-weights to investment grade corporate exposures would better align capital management practices, risk management practices, and broader business judgments. In addition, an investment grade-based standard would also build on decades of investment grade risk determinations made by U.S. banking organizations, under the direction and supervision of the Banking Agencies, ensuring that appropriate safeguards exist. Conceptually, an investment grade-based distinction also aligns with the treatment of real estate and similar exposure categories where there are long-standing risk-weight distinctions within a broad exposure category. For these reasons, the Banking Agencies should consider proposing this approach for adoption in the Generally Applicable Capital Rules.

Basel Approach for Qualifying Retail Exposures.

The current Basel Standardized Approaches provide for a 75% risk weighting for retail exposures that satisfy certain criteria (e.g. the exposures are (i) to individuals or small business, (ii) generated by products such as credit cards and student loans, (iii) part of a diversified portfolio, and (iv) in the aggregate, less than €1 million). This approach was retained in the Proposed Revised Standardized Approach. However, the U.S. never adopted this aspect of the Basel agreement and current U.S. Standardized Approach applies a flat 100% risk weighting for retail exposures. This places U.S. firms at a significant competitive disadvantage to non-U.S. credit card issuers. Consequently, ABA urges the Banking Agencies to adopt the 75% regulatory retail risk weighting approach set forth in the Basel agreement.

[10] Paragraph 30 of the Proposed Revised Standardized Approach.

If the Banking Agencies would like additional information regarding these comments, please contact Hugh Carney, at (202) 663-5324 (hcarney@aba.com).

Sincerely,

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