



March 1, 2012

Mr. Arthur W. Lindo
Senior Associate Director
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Re: Treatment of Unrealized Gains and Losses Under the Basel III
Capital Framework

Dear Mr. Lindo:

This is further to the December 15, 2011 meeting of representatives of The Clearing House Association L.L.C. (“**The Clearing House**”)¹ and the American Bankers Association² (the “**ABA**” and, together with The Clearing House, the “**Associations**”) with you and other members of the staff of the Board of Governors of the Federal Reserve System (the “**Board**”) concerning Basel III’s³ removal of the existing filter of certain unrealized gains and losses on financial instruments (the “**AOCI Filter**”) from regulatory capital components.⁴ We appreciate the time

¹ Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world’s largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost \$2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. See The Clearing House’s web page at www.theclearinghouse.org.

² The ABA represents banks of all sizes and charters and is the voice for the nation’s \$13 trillion banking industry and its two million employees. The majority of the ABA’s members are banks with less than \$165 million in assets.

³ Basel Committee on Banking Supervision (“**BCBS**”), *Basel III: A global regulatory framework for more resilient banks and banking systems* (Dec. 2010) (rev. June 2011) (the “**Basel III capital framework**” or “**Basel III**”).

⁴ The December 15, 2011 meeting followed the submission by The Clearing House of a letter, dated October 27, 2011, to the U.S. banking agencies (the “**Agencies**”), attached as *Annex A*, in which The Clearing House reiterated concerns with Basel III’s removal of the AOCI Filter and addressed certain then recent developments that had heightened concern with this issue. The removal of the AOCI Filter is addressed in paragraph 52 and footnote 10 of the Basel III capital framework.

In this letter, as with the October 27, 2011 letter, we are using the term AOCI Filter to describe Basel III’s proposed removal of the adjustment for unrealized gains or losses recognized on the balance sheet when regulatory capital calculations are made as a reflection of U.S. terminology. Under the Financial Accounting

that the staff took to meet with us on these important matters and submit this letter in response to certain questions asked by the staff at that meeting.

1. The prospective removal of the AOCI Filter will cause banks to shorten the duration of their investment portfolios, with consequences for (among others) the markets for 30-year mortgages, longer-term U.S. Treasury bonds and municipal securities that will become more apparent and pronounced as the implementation of Basel III approaches.

At the meeting, the staff asked the Associations to provide examples of “changes in behavior” that are likely to occur at banks as a result of the elimination of the AOCI Filter, including changes that have occurred to date in anticipation of and preparation for the filter’s removal. In order to minimize the magnitude of unrealized gains and losses from AFS Securities, and the resulting impact from AOCI that, with the removal of the filter, will impact regulatory capital, banks likely will, and some have begun to, shorten the duration of their investment securities portfolios. The fair market value of debt securities with shorter durations is less sensitive to changes in interest rates than that of long-term debt securities. In a rising interest rate environment, the resulting unrealized losses from a shorter duration portfolio will have less of an impact on a bank’s regulatory capital. Although banks must solve for both rising and falling interest rate environments, the current, historically low interest rate environment necessitates that banks, at this time and as a prudential matter, prepare for the former.

We submit that the following changes in behavior are inevitable:

- Banks likely will limit their investments in all longer duration assets, including 30-year Fannie Mae and Freddie Mac mortgage-backed securities and debentures. As these changes in behavior occur on an industry-wide basis, funding for 30-year mortgages will be reduced, perhaps significantly. As only one example of the steps that many banks are taking to limit volatility related to AOCI, in 2011 one large commercial bank sold pass-through mortgage-backed securities representing approximately 20% of its investment securities portfolio, and offset the sale with the purchase of a mix of shorter-duration debt securities and derivatives. This trade was focused

Standards Board’s Accounting Standards Codification (“ASC”) Topic 320, *Investments—Debt and Equity Securities* (formerly Statement of Financial Accounting Standard No. 115), securities held in the available-for-sale account (“AFS Securities”) are carried at fair value, but the changes in fair value are not recorded to the income statement as gains and losses (except to the extent of other than temporary impairment losses). Instead, changes in fair value (both unrealized gains and unrealized losses) are recorded to the accumulated other comprehensive income/loss (“AOCI”) account in shareholders’ equity until realized (*i.e.*, through sale or other than temporary impairment). Under the Agencies’ existing guidelines for regulatory capital calculations, those adjustments to AOCI are reversed out of shareholders’ equity in calculating regulatory capital.

specifically on limiting capital volatility arising from AOCI in the bank, and similar examples will play out as other banks do the same.⁵

- Similarly, as U.S. banks shorten the maturity of debt instruments in their securities portfolios to reduce the impact of unrealized gains and losses (both positive and negative) resulting from changes in interest rates on their regulatory capital, they likely will invest in U.S. Treasury securities with shorter maturities. As one example, one major U.S. bank recently, for the first time in almost three decades, purchased short-term U.S. Treasuries, while at the same time modestly shortening the duration of its mortgage-backed securities portfolio.
- Some banks will shy away from municipal debt offerings in particular, because they tend to be longer dated, in favor of shorter-termed instruments. This likely will have the effect of increasing borrowing costs for municipalities and reducing the liquidity of municipal debt markets.

We recognize that it is too early to quantify the impact of these changes in behavior and the related effects of the removal of the AOCI Filter. The results do not yet appear meaningfully measurable and many other factors impact banks' current decisions about their investment portfolios. For example, the artificially low interest rate environment may distort decision making as some banks choose to maintain longer dated securities portfolios for the time being in an effort to increase yield. We urge both the Agencies and market participants not to take the slow pace of these changes as evidence that these concerns are unwarranted or that these changes will not occur. Banks are taking steps to shorten the duration of their securities portfolios, but are moving slowly in anticipation of the rulemaking process by the Agencies to implement Basel III. The movement towards shorter-term portfolios, however, is almost certain. Furthermore, as the potential implementation of the Basel III capital and liquidity frameworks, and the elimination of the AOCI Filter, approaches, these changes will become more pronounced and occur with accelerating effects. Although it is too early to predict with certainty the magnitude and contours of the consequences on affected markets (e.g., reduced availability of 30-year mortgages, a skewing of maturities of U.S. Treasury securities from the maturity distribution policymakers may desire, or increased cost for municipalities), we believe the impacts are very likely to be significant.

⁵ We think it important to reiterate that, as banks solve for the accounting and regulatory issues related to recognition in regulatory capital of unrealized gains and losses recorded in AOCI, they will risk mismatches in asset-liability management as well as deteriorating interest rate risk profiles. One manner in which banks may attempt to reduce the risk of experiencing unrealized losses recorded in AOCI would be to increase the proportion of floating interest rate assets in their securities portfolios, including by swapping fixed interest rate assets to floating interest rates. Such steps would have the effect of reducing the negative impact on regulatory capital that would occur as interest rates rise. However, where the related funding source is a fixed- or stable-rate funding source, a mismatch between the bank's assets and liabilities may result from such steps.

2. The removal of the AOCI Filter will negatively impact banks' regulatory capital in a rising interest rate environment, which will decrease the ability of banks to lend and to contribute to any related economic recovery through the extension of credit.

Another example of change in behavior that is likely to result from the removal of the AOCI Filter is reduced lending by banks. As discussed at the meeting and noted above, in a rising interest rate environment, banks will incur unrealized losses recorded in AOCI as they mark AFS Securities to market. Under the Basel III capital framework, an increase in market interest rates will put downward pressure on capital levels within the banking system, including in part as a result of unrealized losses recorded in AOCI. As regulatory capital across the banking industry is impacted, the lending capacity of the industry will be affected as well. Potential behavioral changes discussed in Part 1 of this letter, and the importance more broadly of the AOCI Filter's removal, will become more apparent as the implementation of Basel III approaches. It is particularly difficult to measure the impact on lending of this isolated change given other regulatory changes (including higher capital requirements and, more generally, increased regulatory burdens). However, the cumulative impact of this artificial reduction in regulatory capital across the U.S. banking industry is potentially significant and could result in a substantial dampening of any economic recovery that likely would accompany a rising interest rate environment.

We appreciate that the staff is interested in more than just assertions that "lending will come to a halt" as a result of the elimination of the AOCI Filter. It is nonetheless clear that there will be a significant negative impact on lending if the AOCI Filter is eliminated and interest rates were to rise substantially from current rates. We provide the following examples, not to be alarmist, but to show why a negative impact on the ability of banks to lend will occur with the removal of the AOCI Filter in a rising interest rate environment. These examples are all the more relevant given the current, historically low interest rate environment.

For purposes of these examples, we assume a 400 basis point parallel upward shift in the yield curve.⁶ For a bank with 20% of its assets held in AFS Securities, with an average duration of three years, such a shift in the yield curve would cause, absent any other considerations or mitigating actions, an approximate 197 basis point decrease in regulatory capital (on an after-tax basis) as a result of unrealized losses recorded in AOCI that would, with the AOCI Filter eliminated, put significant downward pressure on regulatory capital.⁷ As discussed in Part 3, because the tax effect of those losses would increase the bank's deferred tax assets ("DTAs"), capital could be impacted by as much as another 132 basis points as a result of dollar-for-dollar reductions to common equity Tier 1 ("CET1"), for a total of 329 basis

⁶ The *Interagency Advisory on Interest Rate Risk Management—Frequently Asked Questions* (Jan. 12, 2012), issued by the Agencies, the National Credit Union Administration and the State Liaison Committee, provides, at page 5, that, in the context of stress testing by banks to measure interest rate risk, "[i]n a period of extremely low rates, a +400 basis point shock would provide a meaningful stress scenario" Moreover, the 300 to 425 basis point increases in short- and intermediate-term interest rates observed during 1994 and following May 2004 support the reasonableness of this presumption.

⁷ Attached as *Annex B* is a table showing the calculations for these examples.

points of reduction in CET1 (assuming the bank is already at the 10% individual limit or the 15% aggregate limit, discussed below). The aggregate reduction could constitute 30% or more of such a bank's capital. For example, assuming the bank was operating with a 200 basis point capital cushion over the Basel III thresholds, it would need to shrink its loan portfolio considerably in response to this increase in interest rates to keep its capital ratios above the Basel III thresholds. Because interest rate increases would impact every bank in the United States at the same time, it is unlikely that the capital markets would be readily able to meet the demands for new capital infusions from thousands of banks, with the result that capital ratios would have to be maintained by reductions in bank assets.

We can apply this same approach to U.S. banks on an aggregate basis. As of December 2011, U.S. banks held approximately \$2.5 trillion in investment securities.⁸ The average duration of such investment securities portfolios, and the proportion that are AFS Securities, is difficult to know. Assuming an average duration of three years, which we consider a conservative estimate considering that more than \$1.2 trillion of those securities are reported to be in mortgage-backed securities, and assuming such securities are classified as available-for-sale, a 400 basis point parallel upward shift in the yield curve, absent any other considerations or mitigating actions, would result in U.S. bank regulatory capital being reduced by nearly \$300 billion on an industry-wide basis. Assuming an 8.5% leverage ratio, such a reduction would reduce aggregate lending capacity in the U.S. banking system by over \$3 trillion.⁹

Although these impacts will vary from bank to bank, the reduction in lending will be exacerbated for some. All banks are subject to statutory and supervisory limits on lending and concentration that are tied to measures of regulatory capital. Many banks, including community and mid-sized banks in particular, find these limits to be of practical concern, particularly as it relates to loans to their largest customers. The potential downward pressure on regulatory capital that would arise from a rising interest rate environment will require banks to reduce lending to their bank customers that are near the legal lending limit due to the risk that an increase in interest rates will cause the banks to violate statutory or supervisory lending or concentration limits.¹⁰

⁸ See Federal Reserve Statistical Release H.8 (January 27, 2012).

⁹ This figure would be greater if we factored in the impact on regulatory capital from the reductions in CET1 for mortgage servicing rights ("MSRs") subject to the 10% component and 15% aggregate caps, discussed below in Part 3, while a small portion of this reduction in capital would be absorbed by initial capacity under the 10% cap on DTA.

¹⁰ Given the current, artificially low interest rate environment, the likely next phase in the interest rate cycle will be rising rates, accompanied by declining values in investment securities portfolios, which will create artificially low regulatory capital because the losses are not likely to be realized. We recognize that in a more normal period of interest rate movements the reverse could happen (*i.e.*, rates could decline, increasing values of investment securities portfolios and inflating regulatory capital), but that would not necessarily be good from a safety and soundness perspective either. For further discussion of this concern, see pages 7-9 of our October 27, 2011 letter, attached as *Annex A*.

3. The impact to regulatory capital of the removal of the AOCI Filter is compounded by other aspects of the Basel III capital framework.

It is important to emphasize the fact that the impact to regulatory capital of the removal of the AOCI Filter is compounded by other aspects of the Basel III capital framework, including, in particular, the treatment of DTAs and MSRs. As you know, the Basel III capital framework limits the types of instruments that can be included in CET1 to common shareholders' equity plus a limited amount of other assets, which are capped at 15% of common equity in the aggregate and 10% of common equity for any one component. Because DTAs and MSRs are subject to these limits, for each dollar by which either exceeds 10% of CET1 (or 15% in the aggregate), a bank will be required to subtract a dollar from CET1. If the AOCI Filter is removed, the reduction of CET1 by unrealized losses recorded in AOCI likely will be accompanied by additional charges to CET1 as a result of the treatment of DTAs and MSRs. We provide the following examples to illustrate.

In a rising interest rate environment, each \$1.67 of pre-tax unrealized losses in the debt investment portfolio (for AFS Securities) will result in the after-tax portion of such loss (\$1.00, assuming a combined federal and state corporate tax rate of 40%) reducing CET1 through AOCI (which would also impact shareholders' equity under U.S. Generally Accepted Accounting Principles ("U.S. GAAP")). However, beyond this dollar-for-dollar reduction in capital, the \$0.67 tax effect also will increase the bank's DTA. Once the DTA is over the 10% limit or the 15% aggregate limit, the amount by which this tax effect exceeds such limit will reduce CET1 on a dollar-for-dollar basis (but not shareholders' equity under U.S. GAAP). Given that the DTA may be at or near its 10% individual limit for some banks at the time the Basel III capital framework is proposed to take effect,¹¹ the practical impact is that unrealized losses in the debt investment portfolio have the potential of reducing regulatory capital by 167% of the amount of the unrealized losses for banks that are not able to realize the capital increase related to the increase in DTA that corresponds with the recognition of those losses.¹²

Under existing MSR valuation models, the same rising interest rate environment also would be expected to cause MSR assets to increase in value. The value of MSR assets is derived from the servicing fee paid to the mortgage servicer and typically is in the range of 25 basis points (annualized) times the balance of the mortgages being serviced. The expected life of the mortgage portfolio is the primary driver of the value of the MSR asset. As interest rates increase, the expected life of the mortgage portfolio normally would be expected to increase,

¹¹ For the vast majority of banks, the tax effect of the loan loss reserve is by far the largest factor in the initial size of banks' DTAs. The anticipated shift from an incurred loss model to an expected loss model as the basis for calculating additions to the loan loss reserve is likely to result in both the loan loss reserves and the DTAs increasing for many U.S. banks in the future. We expect that the loan loss reserve could be upwards of 5% to 8% of CET1, and other major contributors, including deferred compensation and other deferred items related to DTA, could easily be another 1% to 2% of CET1, leaving little leeway before many banks would breach the 10% individual limit.

¹² We note that some banks, such as those with large leasing portfolios, may have meaningful deferred tax liabilities, which will offset their DTAs, reducing this effect.

causing the MSR asset to increase in value. As with DTAs, the increase in MSR value will, once over the 10% MSR limit or 15% aggregate limit, be subtracted from CET1 on a dollar-for-dollar basis, further reducing capacity to lend.

Moreover, banks often hedge the risk of prepayments due to changing interest rates related to their MSR assets, so a gain in MSR assets as a result of an increase in interest rates would result in an offsetting loss from the related hedging transaction. Although changes in value of the MSR asset and the related hedges due to increases in interest rates generally offset each other economically (the U.S. GAAP treatment depends on whether the fair value option is elected for the MSR and whether the hedge qualifies in whole or in part under ASC Topic 815, *Derivatives and Hedging* (formerly Statement of Financial Accounting Standard No. 133)), the increase in the value of the MSR asset would be effectively capped at the 10% limit and the 15% aggregate limit for regulatory capital purposes whereas the loss on the hedge would flow through to shareholders' equity (either directly through the income statement or through AOCI, depending on the type of hedge used). As a result, regulatory capital would be further impacted at the same time that rising interest rates would cause unrealized losses from the investment securities portfolio to affect regulatory capital, assuming removal of the AOCI Filter. Because MSRs do not exist in most countries outside the U.S. that likely will be subject to the Basel III capital framework, this will cause U.S. banks that act as mortgage servicers to be at a competitive disadvantage to their non-U.S. counterparts.

Although we previously have urged the Agencies to reconsider these positions,¹³ we raise these issues here to emphasize the interplay between the removal of the AOCI Filter and the components subject to the 10% component and 15% aggregate limits in Basel III and the potential that these issues most likely will exacerbate reductions in regulatory capital in the future.

4. “Loss absorption” capacity, as a principle underpinning regulatory capital, should not require that market value changes unlikely to ever be realized be reflected immediately in going-concern capital.

The staff asked at the December 15 meeting why logical consistency does not require that the AOCI Filter be removed for AFS Securities – simply put, if a particular AFS Security on a day can be liquidated only for a reduced (or increased) mark-to-market price, why should regulatory capital measures not reflect that reduced (or increased) price. The answer is straightforward: for a going concern, the unrealized gains and losses in fact may never be

¹³ See pages 3 and 12-13 of The Clearing House's letter, dated April 16, 2010, and pages 7-8 of the ABA's letter, dated April 15, 2010, in each case to the BCBS with respect to its December 2009 consultative document, *Strengthening the resilience of the banking sector* (the “**Basel III capital proposal**”), and pages 11 (Section 3.4) and A-2-3 to A-2-4 (Section 3) of The Clearing House's letter, dated November 5, 2010, to the United States Department of the Treasury and the Agencies (the “**November 5, 2010 Letter**”), reiterating fundamental concerns with the Basel III capital proposal, and the liquidity proposals set forth in the BCBS's December 2009 consultative document, *International framework for liquidity risk measurement, standards and monitoring* (the “**Basel III liquidity proposal**”).

realized, and, indeed, are highly unlikely to be realized in the amounts recorded on any given day of revaluation. The result is that this proposed change would establish an inherent inconsistency between reported regulatory capital and the going concern value of these securities. If the bank has a need for additional funding, its first approach customarily would not be to sell the securities, thereby realizing the gain or loss, but instead would be to use the securities as collateral to obtain secured financing, including, for example, through repurchase transactions or Federal Home Loan Bank advances. Additionally, when banks need to sell portions of their investment portfolios in order to accommodate changes in funding, they have an opportunity to make a variety of decisions that affect the amount of gain or loss recognized, including which assets to sell, the timing of sales and structuring decisions with respect to particular sale transactions that impact the amount of gain or loss. Further, banks size liquidity buffers and reserves to reflect the volatility in market value of AFS Securities and other assets that may be looked to for liquidity purposes, but the realization of market value changes with respect to these assets can be eliminated through secured financing. Moreover, and a related point, the component of capital that is impacted by the removal of the AOCI Filter is CET1. CET1 is “going concern”, not “gone concern”, capital. The underlying premise of going concern capital is that it supports the bank as a continuing operation for the reasonably foreseeable future as opposed to providing a cushion for depositors or other creditors in a bankruptcy or receivership. The impact on CET1 of changes in the carrying value of AFS Securities should not be premised on “fire sales” but rather should be premised on the expectation that the bank is a going concern, reflecting the role of CET1 as going concern capital.

5. As we have continued to study the impact of the removal of the AOCI Filter, other consequences that we had not previously identified have become apparent.

Although our concerns with the removal of the AOCI Filter to date have focused in large part on the unrealized gains and losses recorded in AOCI resulting from fair value accounting of AFS Securities, other items recorded in AOCI will cause consequences that, on further study, have become apparent. Among these is the difference between projected benefit obligations (“PBO”) and accumulated benefit obligations (“ABO”). PBO is a projected benefit, which takes into account possible future salary increases and other future changes based on going concern status, whereas ABO simply reflects accumulated benefits as of a date and time. The excess of PBO over ABO is recorded to AOCI. Banks with defined benefit plans will see this amount impact their regulatory capital ratios for the first time as a result of the removal of the filter.

6. If the AOCI Filter is removed, the Agencies should maintain the filter at a minimum for AOCI related to certain high-quality liquid assets.

The goal of capital and liquidity reforms should be to maximize financial stability at the least cost to credit availability and economic growth. The issues summarized above and raised in our previous letters have the potential to reduce financial stability, while imposing high costs to credit availability and dampening economic growth. We continue to believe that the Agencies should retain the AOCI Filter.

If the Agencies do not retain the AOCI Filter, we urge them to consider a more tailored approach by retaining the filter for certain high-quality liquid assets, which would reduce the potential impact of these issues on the U.S. banking system and the U.S. economy. For example, securities that qualify for inclusion in the “stock of liquid assets” under the Basel III liquidity framework’s¹⁴ liquidity coverage ratio (“LCR”) have very little credit exposure. As currently proposed, these include U.S. Treasuries and (subject to the Level 2 limitations that, as previously noted, we strongly believe are inappropriate¹⁵) debt securities of Fannie Mae and Freddie Mac. Unrealized gains and losses on these securities recorded to AOCI would relate mostly to interest rate movements and likely would remain unrealized.

We submit that the Agencies should, if the filter is removed, maintain the AOCI Filter at a minimum for AOCI related to high-quality assets used by banking organizations for liquidity management purposes—for example, securities that qualify as liquid assets for the LCR’s numerator and such other assets that, as the Basel III liquidity framework changes or is implemented in the United States, would qualify as liquid assets for these purposes. This would afford banks the opportunity to exclude from regulatory capital calculations changes in fair value related to these high-quality securities that are not likely to be realized given banks’ need to maintain these portfolios for liquidity purposes. Furthermore, retaining the AOCI Filter for AOCI related to these instruments, which have little or no credit risk, would eliminate the unnecessary capital charge on banks based on nothing other than interest rate movements that likely are not reflective of the entity’s net interest rate exposure.

AFS Securities, including high-quality assets held for LCR and other liquidity management purposes, are an important asset-liability management tool for banks. Maintaining the AOCI Filter for such liquid assets would be consistent with paragraphs 71-72 of the Basel III capital framework. Paragraphs 71 and 72 maintain the filter for cash flow hedge reserves that relate to the hedging of items that are not fair valued on the balance sheet—another asset-liability management tool. The BCBS stated that this treatment “removes the element that gives rise to artificial volatility in common equity, as in this case the reserve reflects only one half of the picture.” Retaining the AOCI Filter for these highly liquid assets would further the same goal.

7. Conclusion

The Associations continue to believe strongly that the AOCI Filter should be retained. At the least, we urge the Agencies, as they proceed to propose their own guidelines and regulations implementing Basel III, to withhold judgment and defer action that would eliminate the AOCI Filter until there is further clarity as to the consequences of its removal. Finally, to the extent the Agencies choose to eliminate the filter, we submit that it should be retained for AOCI

¹⁴ BCBS, *Basel III: International framework for liquidity risk measurement, standards and monitoring* (Dec. 2010) (the “**Basel III liquidity framework**”).

¹⁵ See pages A-1-4 to A-1-5 (Section 5) of the November 5, 2010 Letter, and page 7 of the ABA letter, dated April 15, 2010, to the BCBS with respect to the Basel III liquidity proposal.

related to high-quality assets that banking organizations use for liquidity management purposes.

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Thank you again for meeting with us and for considering the concerns raised in this letter. We would welcome the opportunity to meet further to discuss these concerns. If you have any questions, please contact David Wagner of The Clearing House at (212) 613-9883 (david.wagner@theclearinghouse.org) or Hugh Carney of the ABA at (202) 663-5324 (hcarney@aba.com).

Very truly yours,



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