Via electronic delivery October 27, 2011

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

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

Mr. John G. Walsh
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

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

Gentlemen:

The Clearing House Association L.L.C. ("**The Clearing House**")[1] has previously expressed its serious concerns with Basel III's[2] removal of the existing filter of certain unrealized gains and losses on financial instruments (the "**AOCI Filter**") from regulatory capital components.[3] Elimination of the AOCI Filter would:

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 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**").

3 See pages 2, 3 and 10-12 of The Clearing House's letter, dated April 16, 2010, to the BCBS with respect to its December 2009 consultative document, *Strengthening the resilience of the banking sector* (the "**Basel III capital proposal**"), attached hereto as *Annex A*, and pages 11 (Section 3.6) and A-2-2 (Section 2) of The Clearing House's letter, dated November 5, 2010, to the United States Department of the Treasury and the U.S. banking agencies (the "**Agencies**"), attached hereto as *Annex B*, reiterating fundamental concerns with the Basel III capital proposal and the liquidity proposals set forth in the BCBS's consultative

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- force the recognition in capital ratios of unrealized gains and losses that are temporary in nature and result principally from movements in interest rates as opposed to changes in credit risk, that are unlikely to be realized and that typically result in no effect on the banking organization (therefore raising or lowering regulatory capital regardless of real change in risk);

- force banks to maintain ratios of both common equity Tier 1 ("**CET1**") to risk-weighted assets and Tier 1 capital to risk-weighted assets substantially above the levels that would otherwise apply after buffers[4] in order to avoid the sanctions applicable to banks that fall into the buffer range;

- introduce substantial volatility into CET1 and Tier 1 capital as measures of capital; and

- discourage banks from engaging in investing activities that are routinely used as an important asset-liability management tool.

Recent developments have only heightened our concern with this issue. The Clearing House continues 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.

Three principal developments since the December 2010 publication of Basel III have caused us to become even more concerned with the potential removal of the AOCI Filter. They are summarized as follows:

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document, *International framework for liquidity risk measurement, standards and monitoring* (the "**Basel III liquidity proposal**"). The removal of the AOCI Filter is addressed in paragraph 52 and footnote 10 of the Basel III capital framework.

In this 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 FASB's Accounting Standards Codification ("**ASC**") Topic 320, Investments–Debt and Equity Securities, formerly Statement of Financial Accounting Standard No. 115 ("**SFAS 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 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.

[4] See the BCBS's July 2011 consultative document, *Global systemically important banks: Assessment methodology and additional loss insolvency requirement*.

- developments relating to tentative decisions reached by the Financial Accounting Standards Board (the "**FASB**") and new standards issued by the International Accounting Standards Board (the "**IASB**"), but not yet implemented, in the accounting treatment for investment securities under U.S. Generally Accepted Accounting Principles ("**U.S. GAAP**") and International Financial Reporting Standards ("**IFRS**"), respectively, which may exacerbate the volatility in regulatory capital resulting from removal of the AOCI Filter and potentially disadvantage U.S. banks as compared to international banks, depending on the final form and application of the respective proposed U.S. GAAP and finalized IFRS standards;[5]

- increased volatility in shareholders' equity accounts experienced by banks in recent months, directly resulting from changes in fair value of available-for-sale securities recorded in AOCI, as banks increase their holdings of highly liquid debt securities in anticipation of the implementation of the Basel III liquidity framework's[6] liquidity coverage ratio ("**LCR**"); and

- increased awareness, as the result of discussions in all sectors of the U.S. banking community, that the removal of the AOCI Filter adversely impacts banks of all sizes and is equally as important for regional and community banks as it is for large money-center banks.

We have addressed each of these developments in more detail below.

1. The contemplated changes to U.S. GAAP and the finalized but not yet implemented changes to IFRS are complex, and their impact on the shareholders' equity of banks with large investment portfolios is uncertain.

We believe it is critically important that the Agencies, as well as bank regulators in other countries, fully understand the recently proposed changes in U.S. accounting standards and the finalized but not yet implemented changes under IFRS (as applicable), and their impact on regulatory capital, before implementing changes under the Basel III capital framework that would further exacerbate

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5 In frequently asked question No. 4 under "Paragraphs 52-53 (Criteria for Common Equity Tier 1)", included in its *Basel III definition of capital – Frequently asked questions* (October 2011 (update of FAQs published in July 2011)), the BCBS notes that, although there is no change in its reversal of the existing filters for unrealized gains and losses, the BCBS continues to review the issue "taking into account the evolution of the accounting framework and other relevant information." We support that ongoing review and, as discussed in this letter, believe that the evolution of the accounting framework and other developments warrant reconsideration and deferral of the Based III change to existing standards in this regard.

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

volatility in capital measures. We do not believe that regulatory standards can be implemented in isolation from accounting rules. Irrespective of whether removal of the AOCI Filter results in recognizing unrealized "gains" or "losses" in capital, it weakens the effectiveness of regulatory capital ratios as a realistic and appropriate measure of financial strength, discussed further in Part 2, below.

During the same period that international regulators, working through the BCBS, were developing Basel III, the FASB and the IASB continued their joint project to broadly reconsider the accounting treatment of financial instruments. The accounting standards setters' endeavors began shortly before the BCBS released its initial Basel III proposals in December 2009 and have continued after the BCBS's release of its final Basel III framework in December 2010, and in fact continue as of the date of this letter. Changes in accounting standards are likely to introduce increased volatility in shareholders' equity, CET1 and Tier 1 capital, even apart from Basel III's elimination of the AOCI Filter.

More specifically with respect to the actions of the IASB and FASB:

- In November 2009, the IASB issued IFRS 9 *Financial Instruments* ("**IFRS 9**"), which substantially revises the accounting treatment for classification and measurement of financial assets and was amended in October 2010 to include financial liabilities. On August 4, 2011, the IASB issued an exposure draft proposing to postpone the mandatory effective date for IFRS 9 to the first annual reporting period beginning on or after January 1, 2015. IFRS 9 has yet to be endorsed by the European Commission.

- In May 2010, the FASB issued an exposure draft titled *Accounting for Financial Instruments and Revision to the Accounting for Derivative Instruments and Hedging Activities*, which proposes significant changes to accounting standards for financial instruments under U.S. GAAP and, in particular, would substantially revise the accounting for investment securities in ASC Topic 320. In 2011, the FASB further considered the exposure draft and reached tentative decisions that further refine the categories into which financial instruments would be classified (the tentative decisions, together with the May 2010 exposure draft, the "**FASB Proposal**"). The FASB Proposal has not yet been finalized or adopted.

IFRS 9 would establish two primary measurement categories for financial assets: (1) fair value through profit or loss and (2) amortized cost. These would replace the existing IFRS categories of (i) financial assets at fair value through earnings, (ii) held-to-maturity investments, (iii) loans and receivables and (iv) available-for-sale financial assets. When and if IFRS 9 is implemented, IFRS would no longer have a category for debt securities analogous to available-for-sale securities under existing U.S. GAAP standards, where changes in fair value generally are recorded directly to shareholders' equity through AOCI, without being reflected in net income.[7] As a consequence, debt securities previously

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[7] Under IFRS 9, only equity instruments held for strategic purposes could be accounted for at fair value with changes in fair value presented in AOCI.

classified under IFRS as available-for-sale would be accounted for under the amortized cost method or fair value through profit or loss, depending on the bank's investment portfolio business strategy.

Under the FASB Proposal, the existing accounting classifications for investment securities—held-to-maturity, available-for-sale and trading—would be replaced by three new classification and measurement categories, based on the instrument's characteristics and the entity's business strategy for holding that investment: (1) amortized cost ("**Amortized Cost**");[8] (2) fair value–other comprehensive income ("**FV-OCI**"); or (3) fair value–net income ("**FV-NI**").[9] The FASB Proposal's classification criteria for Amortized Cost treatment include a requirement that the holder must have "the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss." This requirement would preclude Amortized Cost treatment for most investment securities, including U.S. Treasuries and other securities issued by public sector entities or corporate debt securities distributed through normal market channels. Investment securities not eligible for Amortized Cost treatment would be classified either as FV-OCI or FV-NI depending on the business strategy under which the investment securities are held. The practical consequences of applying the business strategy criteria remain uncertain and will depend on the final form, interpretation and application of the FASB Proposal, when and if adopted.

The forthcoming changes to international and U.S. accounting standards under IFRS 9 and the FASB Proposal are complex and remain subject to further development (particularly in the case

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[8] The business strategy related to a financial instrument must meet all the following conditions in order to classify the instrument in the Amortized Cost category:

1. Financial assets issued or acquired for which an entity's business strategy, at origination or acquisition of the instrument, is to manage the instruments through customer financing (lending or borrowing) activities. These activities primarily focus on the collection of substantially all the contractual cash flows from the borrower.
2. Financial assets for which the holder of the instrument has the ability to manage credit risk by negotiating any potential adjustment of contractual cash flows with the counterparty in the event of a potential credit loss. Sales or settlements would be limited to circumstances that would minimize losses due to deteriorating credit or to exit a particular market for risk management purposes.
3. Financial assets that are not held for sale at acquisition.

[9] For FV-OCI treatment, financial instruments must meet all of the following conditions:

1. Financial assets issued or acquired in a business activity for which an entity's business strategy, at origination or acquisition of the instruments, is to invest the cash of the entity either to:
   a. Maximize total return by collecting contractual cash flows or selling the instrument, or
   b. Manage the interest rate or liquidity risk of the entity by either holding or selling the instrument; and
2. Financial assets that are not held for sale at acquisition or issuance.

All other financial instruments would be classified as FV-NI.

of the FASB Proposal) and implementation. The FASB Proposal has not been adopted and already has undergone significant changes since its original May 2010 proposal, and IFRS 9 remains to be endorsed by the European Commission.[10] Nonetheless, these proposed standards have the potential to cause the following consequences:

- *Reduce the ability of banks to use held-to-maturity or amortized cost treatment*. Under the FASB Proposal, the current held-to-maturity category would be eliminated and replaced with the more limited Amortized Cost category. As discussed above, most debt securities would not satisfy the business strategy criteria[11] required to qualify for Amortized Cost classification. As a result, under the FASB Proposal, most debt securities, including U.S. Treasury securities, would be carried at fair value and classified as either FV-OCI or FV-NI; either classification would result in unrealized gains and losses impacting shareholders' equity and regulatory capital (assuming, in the case of regulatory capital, the AOCI Filter is eliminated for unrealized gains and losses on FV-OCI securities).

- *Increase the volatility of shareholders' equity and regulatory capital*. Under these accounting standards, more financial instruments would be subject to fair value accounting with unrealized gains and losses impacting shareholders' equity and regulatory capital. As noted above, under the FASB Proposal most debt securities will not qualify for Amortized Cost classification but would be carried at fair value. Under both U.S. GAAP and IFRS standards, more securities would be subject to fair value accounting with unrealized gains and losses flowing directly through the income statement. Additionally, under the FASB Proposal, and IFRS 9 with limited exception,[12] equity securities would be carried at fair value with unrealized gains or losses flowing directly through the income statement, thereby impacting shareholders' equity and, assuming the AOCI Filter is eliminated, regulatory capital.

- *Potentially disadvantage U.S. banks versus non-U.S. banks*. U.S. banks may be disadvantaged as compared to their international counterparts. This is because the FASB Proposal's criteria for Amortized Cost treatment are more restrictive than IFRS 9's criteria and may require U.S. banks to classify securities as FV-OCI or FV-NI that, under IFRS 9, non-U.S. banks would be able to carry at amortized cost. Two otherwise similarly situated banks, one U.S. and one non-U.S., holding a similar investment portfolio may be subject to significantly different impacts on shareholders' equity, which could result in the U.S. bank having

10 Moreover, IASB has indicated that it plans to submit the FASB Proposal to its constituents for comment, which could result in reconsideration of IFRS 9.

11 *See supra* note 8.

12 *See supra* note 7.

significantly more volatility in regulatory capital levels without the AOCI Filter (and, therefore, having to maintain a higher level of capital in order to avoid the sanctions that would apply if the bank falls into its buffer range as a result). Such a disparity would be exacerbated at a time when the Basel III liquidity framework will require banks to carry increased amounts of debt securities on their books to satisfy new liquidity standards. The existence and extent of any potential disparity will depend on both (i) the final form of the FASB Proposal and (ii) how each of IFRS 9 and the FASB's final guidance is interpreted and applied.

We recognize that the final forms of these complex accounting standards are still in flux—as noted above, the FASB Proposal is not in final form and IFRS 9 is not yet effective. The Clearing House believes that the best way to proceed is for the accounting and regulatory capital specialists at the Agencies to meet with representatives from U.S. banks and other experts and, while these deliberations advance, for the Agencies at the least to withhold judgment and defer action that would eliminate the AOCI Filter.

2. Banks will be required to increase their holdings of debt securities in order to comply with the LCR, exacerbating the consequences of removing the AOCI Filter.

Under the Basel III liquidity framework, banks will be required to increase their holdings of highly liquid debt securities, such as U.S. Treasuries and other high-quality investment securities, in order to accommodate the LCR.[13] As noted in The Clearing House's November 5, 2010 letter to the United States Department of the Treasury and the Agencies,[14] research undertaken by The Clearing House indicates an LCR shortfall to full target levels of $1.1 trillion at December 2009.[15] In anticipation of the LCR, banks already have begun to increase their holdings of unencumbered, high-quality securities since the adoption of the Basel III liquidity framework.

Some banks are already experiencing, and all or most banks will eventually experience in some degree, increased volatility in shareholders' equity as they adjust their balance sheets to accommodate the LCR by buying U.S. Treasuries and other high-quality investment securities. Where holdings are being increased to accommodate the LCR, these securities may be classified as held-to-maturity, available-for-sale or trading, depending on the individual bank's investment portfolio management strategy. Although this development is not yet impacting regulatory capital for those

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13 As set forth in pages 4 and 14-19 (Section II.A) of The Clearing House's letter, dated April 16, 2010, to the BCBS with respect to the Basel III liquidity proposal (*see supra* note 3), a sharp increase is due to highly unrealistic and non-empirical assumptions in the liquidity proposal.

14 *See supra* note 3.

15 As previously discussed with the Agencies, The Clearing House has conducted further analysis of the Basel III liquidity proposal, including updating the previous analysis to December 2010. It shows that the LCR shortfall has increased since December 2009 to approximately $1.4 trillion at December 2010.

banks that are classifying such securities as available-for-sale (because the AOCI Filter is still in place), the recent volatility in shareholders' equity resulting from changes in fair value of AFS Securities raises serious concerns about the level of capital volatility banks might expect once the AOCI Filter is removed.[16]

Six member banks of The Clearing House calculated the impact on their ratios of Tier 1 common to risk-weighted assets if the AOCI Filter had been removed as of June 30, 2011 and, on that date, there were a 100 or 200 basis point parallel shift, up or down, in the yield curve. Not surprisingly (given the current low interest rate environment), each of the six banks would suffer a decline in its Tier 1 common ratio if interest rates increased and an increase in its Tier 1 common ratio if interest rates decreased. The arithmetic means of the impacts across the six banks (calculated as a simple average and not on a weighted-average basis based upon total assets or some other measure) were:

- for a 100 or 200 basis point parallel upward shift in the yield curve, -42.5 basis points and -98.5 basis points, respectively (ranging from -9 basis points to -65 basis points for a 100 basis point increase in the yield curve, and from -51 basis points to -144 basis points for a 200 basis point increase in the yield curve); and

- for a 100 basis point or 200 basis point parallel downward shift in the yield curve, +32.7 basis points and +48.0 basis points, respectively (ranging from +22 basis points to +48 basis points for a 100 basis point decrease in the yield curve, and from +17 basis points to +79 basis points for a 200 basis point decrease in the yield curve).

The data for the six banks show substantial volatility in their ratios of Tier 1 common to risk-weighted assets based upon these standard "shock" measures for interest rate risk, implying a need for substantial "cushions" above minimum requirements after buffers.

The consequence of reflecting in regulatory capital increases or decreases in AOCI resulting from unrealized "gains" or "losses" weakens the effectiveness of regulatory capital ratios as a realistic and appropriate measure of financial strength, effectively either understating or overstating the ratios. This is a concern not only for banks and the Agencies as their regulators, but also for analysts and investors that consider regulatory capital ratios.

- Requiring recognition in regulatory capital ratios of unrealized losses that are unlikely to be realized on highly liquid debt securities with little or no credit risk would effectively impose a 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.

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16 *See Annex C* for a chart showing the ratio of AOCI to risk-weighted assets for several U.S. banking organizations from the first quarter of 2005 through the second quarter of 2011.

- Requiring recognition in regulatory capital ratios of unrealized gains that similarly are unlikely to be realized provides a capital benefit to banks that may be illusory[17] and would likely evaporate as the securities ultimately move to maturity.

As banks continue to increase the size of these portfolios, these concerns will only be exacerbated.

Particularly in light of recent experience, we urge the Agencies to study the potential impact on volatility of regulatory capital that may be caused by the removal of the AOCI Filter, with careful consideration of banks' changing balance sheets in response to the LCR. At the very least, we submit that the AOCI Filter should be retained until there has been a meaningful opportunity to analyze the impact of the LCR.[18]

3. Removal of the AOCI Filter presents serious concerns for banks of all sizes, including regional and community banks.

As a result of ongoing discussions throughout the U.S. banking community, there is increased awareness that the issues presented by removal of the AOCI Filter are relevant to banks of all sizes and are equally as important for regional and community banks as for larger banks. We understand representatives of the Agencies have had discussions with a number of regional and community banks concerning this issue and understand that their concerns are generally the same as the concerns of The Clearing House member banks. If the AOCI Filter is removed, all banks – large and small – over time inevitably would hold greater proportions of their debt securities portfolios in short-term instruments in order to reduce their duration and the impact on regulatory capital (both positive and negative) of interest rate movements. Municipal offerings in particular would be hurt because they

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[17] This is a very real scenario for high-grade debt securities purchased by banks in the pre-crisis higher interest rate environment.

[18] Securities that qualify for inclusion in the "stock of liquid assets" under the LCR, including U.S. Treasuries and (subject to the Level 2 limitations that, as previously noted, we strongly believe are inappropriate) debt securities of Fannie Mae and Freddie Mac, have very little credit exposure. Unrealized gains/losses on these securities recorded to AOCI would relate mostly to interest rate movements and likely would remain unrealized unless the security is sold. As the Agencies consider how to implement Basel III, including the treatment of the AOCI Filter, we submit that maintaining the AOCI Filter at a minimum for AOCI related to securities that qualify as liquid assets for the LCR's numerator would afford banks the opportunity to exclude from regulatory capital calculations changes in fair value related to these high-quality securities that generally are not driven by credit. Assets that are held as available-for-sale, including assets held for LCR purposes, are an important asset-liability management tool for banks (as discussed in our previous comment letters and mentioned in the introduction to this letter and in Part 3, below). Maintaining the AOCI Filter at least for LCR liquid assets would be consistent with paragraphs 71-72 of the Basel III capital framework, which 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.

tend to be longer dated; banks generally will shy away from them. More broadly, banks likely will limit their investments in all longer duration assets, including Fannie Mae and Freddie Mac mortgage-backed securities and debentures and even U.S. Treasury securities.

Comparable treatment of banks across the size spectrum, including with respect to the definitions of the components of capital, is critically important. We strongly believe it would not be appropriate to apply the AOCI Filter differently to regional and community banks as opposed to larger banks (for example, by retaining the AOCI Filter for a category of smaller banks but applying it to others). Not treating banks of all sizes alike in this regard would create a considerable disparity in the capital consequences of fundamental balance sheet management decisions. That disparity would be sufficiently powerful to alter franchise development goals and impact the competitive landscape.

4. Conclusion

The Clearing House continues to believe strongly that the AOCI Filter should be retained. At the least (and for all of the foregoing reasons), 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.

* * *

Thank you for considering the concerns raised in this letter. Given the complex nature of the accounting and other topics raised in this letter, we would welcome the opportunity to martial the appropriate capital and accounting experts within our member banks to meet with their counterparts at the Agencies to discuss these concerns. If you have any questions, please contact Eli Peterson at (202) 649-4602 (eli.peterson@theclearinghouse.org).

Very truly yours,

Paul Saltzman

President
The Clearing House Association L.L.C.

EVP and General Counsel
The Clearing House Payments Company

cc: Mr. Arthur W. Lindo
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April 16, 2010

Basel Committee on Banking Supervision
Bank for International Settlements
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Switzerland

Re: Proposals to Strengthen Capital Regulation

Ladies and Gentlemen:

The Clearing House Association L.L.C. ("*The Clearing House*"), an association of major commercial banks[1], is pleased to comment on the Basel Committee's December 2009 consultative document (the "*CD*"), *Strengthening the resilience of the banking sector* (the "*Proposals*").[2] The need to strengthen the regulation of capital in the financial sector is clear. We believe that many of the key concepts in the Proposals are sound, and we support their ultimate implementation. These include the heightened focus on Common Equity, which, as recent events suggest, is of particular concern to market participants in times of distress. However, we also have serious concerns with a number of aspects of the Proposals and are committed to working with the Committee and our national regulators to address those concerns.

1 The member banks of The Clearing House are Bank of America, N.A., The Bank of New York Mellon, Capital One, N.A., Citibank, N.A., Deutsche Bank Trust Company Americas, HSBC Bank USA, N.A., JPMorgan Chase Bank, N.A., The Royal Bank of Scotland N.V., UBS AG, U.S. Bank N.A. and Wells Fargo Bank, N.A. The following members of our affiliate, The Clearing House Payments Company L.L.C., participated in the preparation of this letter and endorse its positions: Branch Banking and Trust Company, Comerica Bank, KeyBank, N.A., PNC Bank, N.A., and Union Bank, N.A.

2 The Clearing House is submitting a separate letter commenting on the Committee's liquidity proposal, *International framework for liquidity risk measurement, standards and monitoring* (the "*Liquidity Proposals*"). Additionally, a number of The Clearing House banks are submitting their own comment letters on the Proposals and the Liquidity Proposals, including in many cases comments on aspects of the Proposals and Liquidity Proposals that particularly affect the operations of those banks.

Capitalized terms used herein and not otherwise defined are used with the meanings assigned to them as in the CD. Paragraph references are to paragraphs in the CD.

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EXECUTIVE SUMMARY

The Clearing House supports the goals that the Committee seeks to achieve with the Proposals and is committed to working with the Committee and our national regulators to achieve a workable solution to the need for enhanced capital standards. We believe, however, that the Proposals are seriously flawed.

A. Fundamental Concerns

1. Macroeconomic Impact. We are very concerned that the capital reforms reflected in the Proposals have been developed without due regard to other possible reforms of financial regulation, including the Liquidity Proposals, and that the macroeconomic consequences of financial reform, considered collectively, are not adequately understood. Capital reform cannot be evaluated in isolation and, of course, will not be implemented in isolation. We are concerned that the Proposals and other financial reforms, taken together, will have significant unintended consequences on banks, their customers and national economies, including reduced credit availability, higher costs for loans and other banking services, further growth of the unregulated shadow-banking system, and reduced returns on equity investments in common shares of banks, making it difficult if not impossible for banks to attract capital on reasonable terms.

2. Competitive Equality. The Clearing House supports the objective that capital regulations apply to banks in a consistent way across jurisdictions, but some flexibility is necessary so that various jurisdictional differences – in such areas as tax, accounting and legal requirements – do not result in banks in some jurisdictions being treated unfairly when compared to banks in other jurisdictions. The Proposals contain several features that inherently create competitive inequality. These include the exclusion of U.S.-style trust preferred securities from Tier 1 Capital, the requirement that all intangible assets (including readily marketable mortgage-servicing rights) be deducted from Common Equity, and, in the denominator of the leverage ratio, (i) the failure to recognize legally enforceable netting arrangements and (ii) the inclusion of unconditionally cancellable commitments.

3. Opportunity to Comment on the Revised Proposals. The Clearing House believes that banks cannot adequately evaluate the consequences of the Proposals without knowing what ratios the Committee will propose. The Clearing House therefore believes that it is *essential* that the Committee publish revised Proposals containing the proposed ratios, as well as the aggregate result of the QIS process and other information, for additional comment before issuing a final set of standards.

B. Key Concepts

1. Adjustments to Common Equity. We submit that certain of the proposed asset-type deductions from Common Equity, and hence from Tier 1 Capital, are inconsistent with the true value of the assets, are extraordinarily conservative and foster competitive inequality. In addition, the elimination of the "filter" for certain unrealized gains and losses would substantially increase the volatility of banks' regulatory capital. Our greatest concerns include

the Proposals' requirements that, in direct contrast to longstanding regulatory practice, 100% of the following items (above designated thresholds in the case of investments in unconsolidated financial entities) be deducted or "filtered" from Common Equity:

- Intangibles. The Proposals would significantly alter current regulatory practice and require all intangibles to be deducted from Tier 1 capital. The Clearing House believes, however, that, consistent with longstanding regulatory practice, certain intangibles, including mortgage-servicing assets, nonmortgage-servicing assets and purchased credit-card relationships, have demonstrated realizable value across credit cycles and should not be deducted from Tier 1 Capital.

- Unrealized Gains and Losses Recognized on the Balance Sheet. The required addition of unrealized gains or deduction of unrealized losses as required by the Proposals would deprive banks of an important asset-liability management tool, force the recognition of gains and losses that may never be realized, introduce substantial volatility into regulatory capital measures, and have a decidedly procyclical effect. The Clearing House believes that the current practice should be maintained or that national regulators should have the flexibility to do so.

- Deferred Tax Assets ("*DTAs*"). The strength and realizability of DTAs reflected in financial statements depends in substantial part on the accounting standards applied in a particular jurisdiction. We urge the Committee to permit national regulators discretion in the treatment of DTAs rather than automatically require that 100% of DTAs dependent upon future income be deducted from Tier 1 Capital.

- Investments in Capital of Unconsolidated Financial Institutions and Insurance Entities. While The Clearing House agrees that the capital treatment of banks' investments in unconsolidated entities should be subject to special scrutiny, we do not believe that the proposed automatic required 100% deduction for all such investments above designated thresholds is sensible, in part because the rule would deter transactions that would otherwise be desirable or reduce risk.

2. Tier 1 Additional Going Concern Capital. The Clearing House supports the objective of making the components of Tier 1 Capital, including Tier 1 Additional Going Concern Capital, as strong as possible, but we believe that it is inappropriate to adopt an international standard that would create significant cost-of-capital advantages for institutions in different jurisdictions. Yet, the proposals would do precisely that by excluding from the Tier 1 Capital of U.S. banks instruments that are treated as debt for tax purposes (principally trust preferred securities), while accommodating European-style hybrid securities. We urge the Committee to permit national regulators the flexibility to permit the inclusion of tax-advantaged instruments in Tier 1 Additional Going Concern Capital, subject to certain limitations. We also

standards, including the accounting treatment of credit expense (both as to timing and amount) and of deferred tax assets.

We comment on each of the aforementioned items below. We urge the Committee to consider, as an alternative to requiring 100% deduction of these items from Common Equity as reflected in the Proposals, addressing any concerns as a matter of transparency by requiring banks to disclose the amounts of these items.

1. Unrealized Gains or Losses Recognized on the Balance Sheet. Under U.S. GAAP,[5] certain unrealized gains and losses on securities in the investment portfolio that are classified as "*available for sale*" are recorded directly to equity, as opposed to being treated as income or expense items for income statement purposes. Under current regulatory reporting practice in the United States, those unrealized gains and losses are "filtered out" from the calculation of Tier 1 Capital.[6] The Clearing House strongly believes that this practice should be continued or, at the least, national regulators should have the flexibility to permit its continuance on a jurisdiction-by-jurisdiction basis depending upon their consideration of relevant factors, including the accounting principles applicable in the relevant jurisdiction. To do otherwise as contemplated by Paragraph 96, at least in the case of U.S. banks, would (i) deprive banks of an important asset-liability management tool, (ii) force the recognition of unrealized gains and losses that may never be realized and (iii) introduce substantial volatility into Common Equity and Tier 1 Capital as measures of capital. It would also have a decidedly procyclical effect.

First, with respect to asset-liability management, banks customarily record the predominant portion of their investment portfolios as available for sale because purchases and sales of investment securities are a primary tool for accommodating variability in funding levels, particularly deposit inflows and outflows. We believe that internationally active U.S. banks record substantially all of their investment portfolios as available for sale. When, during the financial crisis, banks experienced substantial deposit inflows that they anticipated would be temporary, the corresponding balance sheet adjustment to the increase in deposits generally was

5 The U.S. Financial Accounting Standards Board's ("*FASB*") Financial Accounting Statement No. 115 (as amended), "Accounting for Certain Investments in Debt and Equity Securities", and related accounting guidance address the financial statement treatment under U.S. GAAP of investments in equity securities that have readily determinable fair values and all investments in debt securities. Those are the investment securities addressed in this section. For U.S. banks, accumulated other comprehensive income or loss (hereinafter in either case, "*AOCI*") includes unrealized gains and losses on investment securities that the bank has classified as "*available for sale*" (that is, they are not "*held-to-maturity securities*", which are securities that the bank has a positive intent and ability to hold to maturity, or "*trading securities*", which are securities that the bank bought and holds principally for the purpose of selling them in the near term).

6 By "filtering out" unrealized gains and losses from Tier 1 Capital, we mean that, for the relevant schedules to regulatory reports on which banks calculate Tier 1 Capital by beginning with GAAP shareholders' equity and making adjustments, unrealized losses are added back into the starting point of the calculation and unrealized gains are subtracted out of the starting point of the calculation.

a purchase of investment securities recorded as available for sale. If the treatment contemplated by Paragraph 96 were in fact adopted, in order to avoid recognizing for regulatory capital purposes market-related losses (or gains) that may never be recognized, and suffering the related volatility in regulatory capital, there would be a strong incentive for banks to record as held to maturity investment securities purchased to address variability of funding. In that event, however, the relevant accounting rules would generally require banks to hold such securities until maturity. Banks would then need to take other steps to address variability in funding. That incentive is contrary to sound asset-liability management practices, where variability in funding should be matched by variability in assets. Moreover, there would be broader consequences that need to be considered and understood, including a bias toward investing in securities with shorter maturities (with a related adverse impact on sovereigns and other issuers who wish to raise longer-term debt) and likely steps to reduce variability of funding, including through adjustments in the pricing of deposits.

Second, the unrealized gains and losses in fact may never be realized, and, indeed, are highly unlikely to be realized in the amounts recorded on the day of any revaluation. The result is that this proposed change will establish an inherent inaccuracy in reported regulatory capital. 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.

Third, looking only at historical data and without attempting to factor in behavioral changes that would likely result from the implementation of Paragraph 96, reflecting unrealized gains and losses in Common Equity would make Common Equity a very volatile measure of capital. We have included in Annex 1, for 18 large U.S. bank holding companies,[7] calculations of the impact of requiring that AOCI not be filtered out of Tier 1 Capital as of the end of each quarter for quarters ending from March 31, 2006 through December 31, 2009. As is apparent from Annex 1, the Tier 1 Capital Ratio would vary widely for individual banks from period-to-period, both up and down, if AOCI were not filtered out from Tier 1 Capital.

Fourth, and related to points "second" and "third" above, avoiding recognition of gains and losses that likely will never be realized and the related impact on the volatility of capital is particularly important to banks with extensive international operations, whether conducted through branches or subsidiary banks in other countries (both of which are included in the term "*bank*" as used in this paragraph). Many countries require banks operating within their borders to hold designated amounts of the country's sovereign debt. As a consequence, internationally active banks hold large amounts of sovereign debt in their investment portfolios. Moreover, the Liquidity Proposals (particularly the Liquidity Coverage Ratio provided for in

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7 The bank holding companies for which data are included in Annex 1 are 17 of the 19 bank holding companies that were subject to the Federal Reserve's 2009 Supervisory Capital Assessment Program, or "*SCAP*", plus Northern Trust Company. The two SCAP bank holding companies for which we did not include data in Annex 1 are GMAC and MetLife.

those proposals) would force internationally active banks, as well as other banks to which the Proposals may apply, to increase their investments in sovereign debt. Investments in sovereign debt generally have very little credit risk and, for the most part, tend to be held to maturity notwithstanding that they are available for sale. Requiring recognition of unrealized losses on sovereign debt effectively imposes a capital charge on banks from interest rate movements, without recognition of the off-setting changes in value of the bank's equity on a fully-marked basis that is inherent in changes in the fair value of its liabilities.

Moreover, implementation of Paragraph 96 is decidedly procyclical. In order to maintain a sufficient margin above minimum or targeted capital ratios, banks would be compelled to issue Common Equity or other capital instruments whenever their investment portfolios experience temporary declines in value. Those temporary declines are likely to be experienced across the banking sector at the same time, and the related capital-raising is likely to occur during a period of distress in the economic cycle, not a period of strength. This would sharply raise the cost of capital or even preclude some institutions from access to capital at any cost.

2. Intangibles. Paragraph 97 would require that all intangibles be deducted from Common Equity. Although we believe there is sufficient uncertainty as to the realizable value of certain intangible assets to warrant their deduction, we do not believe that is the case for all intangible assets. Mortgage-servicing assets, nonmortgage- servicing assets and purchased credit-card relationships have shown themselves to have demonstrable realizable value over sustained periods.

Servicing assets represent a real cashflow entitlement that is transferable, akin to an interest-only security with prepayment risk. Credit-card account relationships have demonstrable value, as reflected in numerous purchases and sales of credit card portfolios over the years. Credit card usage patterns are predictable and, accordingly, banks have substantial comfort with the models they use to value credit card portfolios. We believe that these intangibles should continue not to be deducted as lesser quality assets from Common Equity or the other components of capital in accordance with existing standards, subject to the discretion of national regulators.

For U.S. banks, mortgage-servicing rights are particularly important. The 18 large U.S. bank holding companies for which AOCI data are provided in Annex 1 (as discussed above) recorded more than $67 billion of mortgage-servicing rights on their financial statements at December 31, 2009. By comparison, mortgage-servicing rights are an insignificant asset class for large European banks.

3. Deferred Tax Assets. Paragraph 98 would require that all DTAs that rely on future profitability of the bank to be realized be deducted from Common Equity. The strength and realizability of DTAs reflected in financial statements of banks in a particular jurisdiction largely depend upon the rigor of the accounting standards applied under generally accepted accounting principles in that jurisdiction – e.g., in the United States, the establishment of the "valuation allowance" required by U.S. GAAP and discussed further below. We urge the

The Clearing House

November 5, 2010

The Honorable Timothy F. Geithner
Secretary
United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Ben S. Bernanke
Chairman
Board of Governors of the Federal Reserve System
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Washington, D.C. 20551

The Honorable Sheila C. Bair
Chairman
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Mr. John G. Walsh
Acting Comptroller of the Currency
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Mr. John E. Bowman
Acting Director
Office of Thrift Supervision
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Washington, D.C. 20552

Mr. William C. Dudley
President
Federal Reserve Bank of New York
33 Liberty Street
New York, New York 10045

Re: Reform of Capital and Liquidity Regulation as Applied to U.S. Banks

Dear Sir or Madam:

The Clearing House Association L.L.C. ("**TCH**"), an association of major commercial banks,[1] is deeply interested in the U.S. and international initiatives to reform capital and liquidity regulation.[2] We respectfully submit for your consideration a number of critical issues

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[1] Established in 1853, TCH is the United States' oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. TCH is a nonpartisan advocacy organization representing through regulatory comment letters, amicus briefs, and white papers the interests of its member 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 TCH's web page at www.theclearinghouse.org

[2] See our comment letters dated: (i) April 16, 2010 (responding to the Basel Committee's consultative document entitled *Strengthening the resilience of the banking sector* (referred to herein as the "**December capital proposals**")); (ii) April 16, 2010 (responding to the Basel Committee's December 2009 consultative

that are secured by a collateral pool, typically consisting of residential mortgages). Presently, there is no analogous covered-bond market in the United States. U.S. banks primarily finance their mortgage originations through issuances of mortgage-backed securities in securitization transactions. If covered bonds are to be included as liquid assets for LCR purposes, then we urge the U.S. banking agencies to include securities unique to the U.S. market that we believe are equally liquid (*e.g*., high-quality mortgage-backed securities and municipal obligations).

3.4 MSRs are valuable assets that reflect entitlement to real cashflow (identical, as to substance, to non-credit-enhancing interest only securities) and have ascertainable value. We believe the Basel III limitation on MSRs should follow the current U.S. standards (under which MSRs and certain other servicing assets and account relationships includible in capital are limited to the lesser of 90% of fair value or 100% of book value but, subject to that limitation, may be included in capital up to 100% of Tier 1 capital) or, at the least, be relaxed from the 10%/15% "bucket" approach outlined in the July Release. As discussed further in Annex 2, we also believe Basel III's proposed limitations on DTAs and investments in non-consolidated financial entities should not be more restrictive than current U.S. standards.

3.5 The phase-out of trust preferred securities and cumulative preferred stock as components of Tier 1 capital, required both by Basel III and Dodd-Frank, should be implemented during the three years commencing January 1, 2013 on the Basel III basis set forth in the July Release (*i.e*., by increments of 10% on January 1, 2013 and 2014) so as not to disadvantage U.S. banks with respect to disqualified instruments, as compared to banks in other jurisdictions, any more than is necessary during that period.

3.6 TCH continues to believe that the existing filter of unrealized gains and losses of financial instruments from regulatory capital components should be maintained and that paragraph 96 of the December capital proposals should not be implemented. Because of the current U.S. GAAP requirement that banks mark to market their available for sale investment securities portfolios, eliminating the filter will introduce substantial volatility in capital ratios with respect to changes in fair value that are unlikely to ever be realized in net income. The U.S. banking agencies should re-address this issue with their international counterparts as the Basel Committee proceeds to finalize the Basel III capital proposals.

ultimately is eliminated, Tier 1 common equity will become a very volatile measure. If sanctions apply to any invasion of the conservation capital buffer, banks will have no choice but to maintain sufficient capital cushions to preclude falling within the buffer zone merely because of the volatility of its Tier 1 common equity.

If a bank dips into its buffer zone but maintains the most substantial part of its buffer, we believe that, instead of automatic and immediate sanctions, the buffer should be implemented as a Pillar 2 matter so as to inject counter-cyclicality into the system over the business cycle, separate from any counter-cyclical buffer, which we understand would generally apply only in the most extreme circumstances like the recent crisis. During "normal" times, banks ordinarily should be expected to meet the full Basel minimum requirements plus the buffer. But in periods of general macroeconomic downturns (or in supervisory modelings of such scenarios), the focus should shift to the capital minima and institutions should be permitted to fall into the buffer zone.[11] The Pillar 2 supervisory evaluations of the consequences of a bank falling into the buffer zone should take into account the reasons why that happened (e.g., a temporary factor, an acquisition of a troubled institution, or market changes that are not within the bank's control).

Finally, sanctions for falling into the buffer zone should be limited to constraints on capital distributions and should not include operational constraints of the type included in the U.S. banking agencies' prompt corrective action regulations. This seems to be what the Basel Committee contemplated in the December 2009 capital proposals (see paragraphs 256-258).

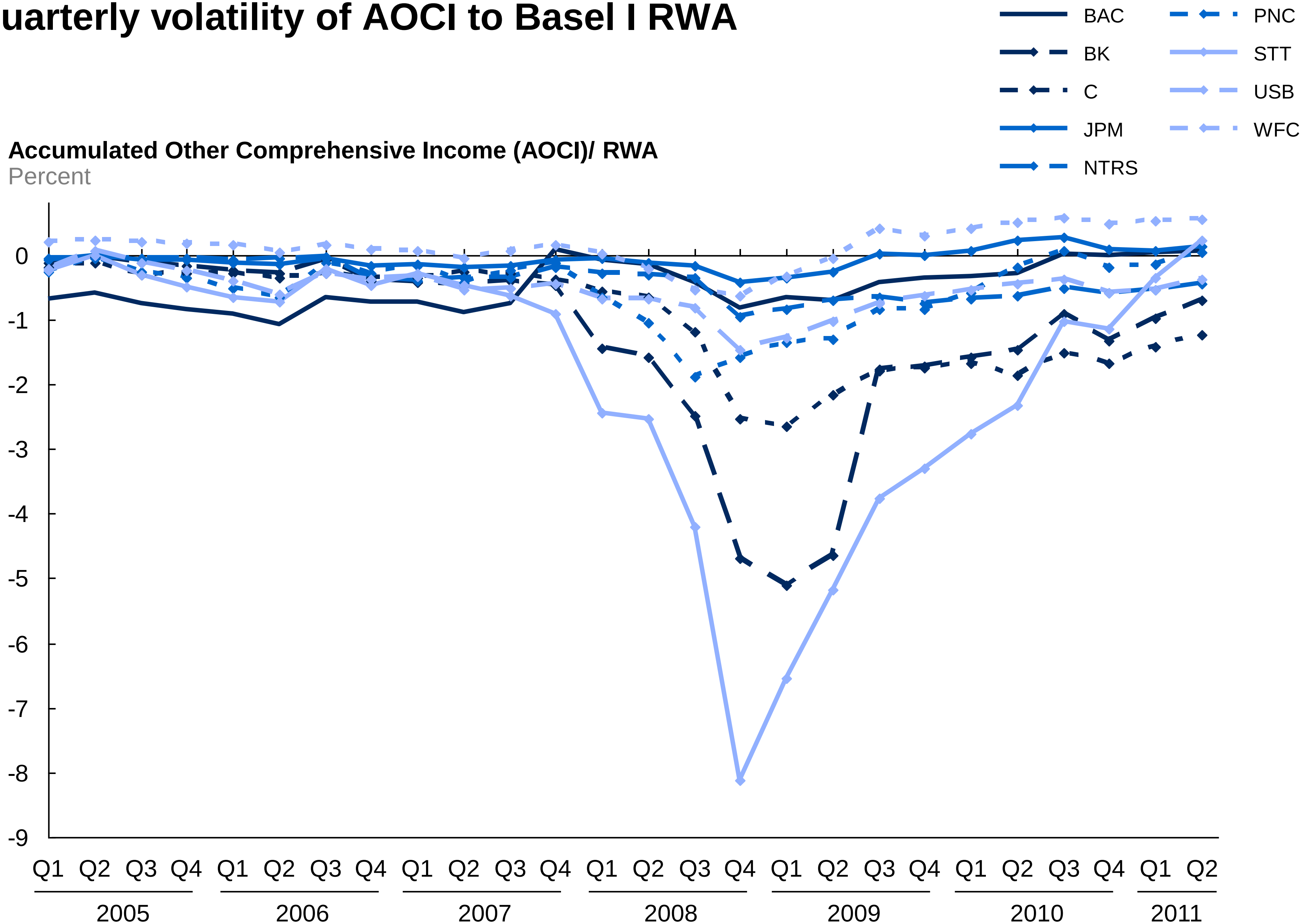
2. TCH continues to believe that the existing filter of unrealized gains and losses of financial instruments from regulatory capital components should be maintained and that paragraph 96 of the December capital proposals should not be implemented.

We discussed this issue at length in our April 16, 2010 comment letter on the December capital proposals and referenced it in item 2 of this Annex, above. For U.S. banks the consequence of reflecting in Tier 1 common and Tier 1 capital unrealized gains and losses on investment securities that the bank has classified as available for sale will introduce substantial volatility in capital ratios with respect to changes in fair value that are unlikely to ever be realized in net income.

The September Release did not address the Basel Committee's thoughts with respect to this issue. The U.S. banking agencies should re-address this issue with their international counterparts as they proceed to finalize the Basel III capital proposals.

11 The Basel Committee appears to agree with this premise. *See, e.g.*, December proposals, para. 248 ("These buffers should be capable of being drawn down through losses and large enough to enable banks to maintain capital levels above the minimum requirement throughout a significant sector-wide downturn").

Quarterly volatility of AOCI to Basel I RWA



SOURCE: SNL Financial