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Secretariat of the Basel Committee on Banking Supervision
Bank for International Settlements
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Re: Comments on Consultative Documents: Strengthening the resilience of the banking system and International framework for liquidity risk measurement, standards, and monitoring, issued December 2009.

To the Committee:

Fifth Third Bancorp is submitting this comment letter in response to the Consultative Documents, "International framework for liquidity risk measurement, standards, and monitoring" (Liquidity Proposal) and "Strengthening the resilience of the banking system" (Capital Proposal), issued by the Basel Committee on Banking Supervision (Committee) in December 2009. Fifth Third appreciates the opportunity to comment on the proposals, and respectfully requests that the Committee consider the comments contained in this letter in determining the final rules.

Fifth Third supports the Committee's objective of increasing the global financial system's ability to withstand shocks by strengthening capital and liquidity standards. However, Fifth Third has concerns about the potential unintended consequences of the Capital and Liquidity Proposals as currently drafted. The Capital and Liquidity Proposals, separately and in conjunction with each other, are likely to lead to a decrease in the availability of credit and an increase in the cost of credit, particularly to the small business sector and consumers in the United States. This outcome is contrary to the public policy objective of increasing lending in order to stimulate economic growth.

Liquidity Proposal

Fifth Third agrees with the Committee that the recent financial crisis highlighted the importance of maintenance of adequate sources of liquidity by banks to weather idiosyncratic issues, and to supplement the liquidity provided by central banks in a systemic crisis. However, Fifth Third has considerable concerns regarding the concepts underlying the Liquidity Proposal, the specifics of the proposed liquidity metrics, and the unintended consequences of the Liquidity Proposal in isolation, and in combination with the Capital Proposal.

A core function of banks in the United States, particularly of regional banks that do not have substantial market making and dealer activities, is to lend to and take deposits from businesses and consumers. This activity results in a maturity and liquidity mismatch as it

involves the transformation of short-term customer deposits into long-term loans to borrowers. This "maturity transformation" serves the vital role of allocating capital to productive investment, while satisfying savers' desire for safety and ready access to their cash. In order to carry out their core function, banks have to accept the maturity mismatch risk and manage this process of maturity transformation. It is important to remember that the natural preferences of borrowers and savers are normally in conflict and cannot be efficiently and economically satisfied without the intermediation and transformation function performed by banks. Banks lower the cost of capital and raise the supply of credit by assuming the risk of a sudden demand for cash from depositors. Across a large actuarial base of depositors, this is a very manageable risk in normal circumstances. Banks maintain sources of liquidity to ensure that they are able to give depositors their money on demand. But in a crisis, a backstop is required and settled policy since the Great Depression has had the government play this role in the U.S. The ultimate guarantor of system-wide liquidity in the United States is of course the Discount Window, but confidence is maintained and the odds of an actual crisis reduced through the familiar tool of deposit insurance administered by the Federal Deposit Insurance Corporation (FDIC) and by access to the Federal Home Loan Bank (FHLB) system.

U.S. banks use high quality mortgage loans to access funding on both short-term and long-term bases from the FHLB system. In addition, banks have a latent source of liquidity that is rarely utilized, but is available in the event of contingencies, in the form of the ability to borrow from the Federal Reserve Discount Window using high quality consumer and business loans on their balance sheet as collateral. These loan-based sources of liquidity are of particular importance to regional banks, whose business model does not allow them to maintain large quantities of highly marketable securities relative to the size of their balance sheets. We believe it is crucial that any final rule recognize the benefits FDIC and FHLB membership provide in allowing banks to make more loans and with longer terms than would otherwise be possible. Failing to give adequate credit to these tools in the Liquidity Proposal would force banks to raise redundant liquidity in the recognized forms of Liquid Assets and term borrowings

While we understand the desire to have banks maintain a stock of liquidity, it should be clearly recognized by public policy makers and the Basel Committee that if banks are required to hold larger stores of liquidity on their balance sheet to eliminate the perceived contingent risk of maturity transformation, the availability of credit will be reduced and the cost of credit will go up. Given the Liquidity Proposal as currently drafted, banks, particularly regional banks whose balance sheets are primarily composed of loan and deposits, will have to add liquidity by buying government securities instead of lending, and fund those purchases by issuing term deposits or long term debt. This will divert funds from loans to government securities, thereby reducing the flow of credit to the economy, and sharply reduce the profitability of banks, thereby increasing the cost of credit, as they try to earn a reasonable rate of return in order to serve their various stakeholders. Banks also need to earn appropriate returns relative to their risks in order to maintain a safe and sound banking system. These effects, which would be a necessary consequence of adapting to these requirements as drafted, would be in direct conflict with

the stated public policy objectives in the United States of increasing lending, particularly to small businesses and consumers, in order to stimulate economic activity and create jobs to reduce the current high rate of unemployment.

Given that this the first time that global standards for liquidity and funding have been proposed, and given the potentially significant impact that these standards could have on the economy, Fifth Third urges the Committee to release a more detailed version of the Liquidity Proposal after the QIS study is completed and facilitate extensive discussion on the revised proposals, by soliciting comments on them and perhaps by conducting another QIS. Phase-in rules should also be given due care and deliberation.

Fifth Third has a number of concerns regarding specific aspects of the Liquidity Proposal. Among them are the following:

- Exclusion of debt issued by and mortgage-backed securities guaranteed by government sponsored enterprises from the set of highly liquid securities
- No consideration given to loans as a source of liquidity
- Punitively high deposit run-off assumptions that are not representative of recent experience during the financial crisis
- High draw assumptions on credit and liquidity facilities

Definition of Liquid Assets

Within the definition of the Liquidity Coverage Ratio (LCR), the current proposal only gives full liquidity credit to securities issued directly by a government, and excludes many other liquid securities. In particular, a primary source of liquidity for many U.S. regional banks is their holdings of debt issued by and mortgage-backed securities guaranteed by government sponsored enterprises (agency securities). Excluding agency securities from the list of highly liquid securities will force U.S. banks to shift the composition of their portfolios out of agencies into sovereign debt. Such a shift will lower the demand for mortgage-backed securities and very likely increase the rate charged to consumers for mortgages, thereby retarding the healing of the housing sector in the U.S. It will also lower bank profitability by forcing them to hold lower yielding sovereign debt, resulting in higher loan rates and lower deposit rates as banks try to maintain an adequate level of profitability. The narrow definition of liquid assets would also have the undesirable consequence of increasing the concentration of a single asset class across all bank balance sheets.

Equally importantly, the Liquidity Proposal does not recognize the liquidity value of high quality loans on bank balance sheets. Within the U.S., the FHLB is a regular source of funding to a variety of banking institutions, wherein banks pledge high quality mortgage loans to obtain liquidity and funding. This source of liquidity is a very important and flexible tool used to support mortgage lending in the U.S. This type of funding is not temporary extraordinary governmental support and has demonstrated its consistent availability and value in the financial crisis. It is important to note that the FHLB system is capitalized by its member banks, not the government. Moreover, it is an important

source of diversification in regional bank funding. Eliminating this source of liquidity from the definition of liquid assets will further reduce the availability and increase the cost of mortgage credit. Given that stabilization of the housing sector is regarded by most economists as a primary contributor to the resumption of strong economic growth, and that a stable housing sector depends on an adequate flow of mortgage credit, the Liquidity Proposal, with its exclusion of agency securities and mortgage loans from the list of qualifying liquid assets, appears to be at odds with important public policy objectives in the United States. Fifth Third strongly recommends that for purposes of both the LCR and the Net Stable Funding Ratio (NSFR), the definition of liquid assets be expanded to include agency securities as well as assets pledgeable to the FHLB.

Deposit Runoff Assumptions

The deposit runoff assumptions in the Liquidity Proposal are extremely punitive and are not reflective of observed deposit activity during the recent crisis. These runoff assumptions artificially reduce the liquidity value of deposits and will lead to banks' shifting from core customer deposits such as Savings and Money Market accounts to term deposits (Certificates of Deposit), thereby causing customers to have less liquid deposits. Paradoxically, the deposit outflow assumptions would also lead to a shift from core deposits to term wholesale funding, which is at odds with the way most banks in the U.S. perceive the relative value of customer deposits versus wholesale funding. It is interesting to note that in general, broker-dealers with assets funded by wholesale funding appear to be the most liquid entities based on the Liquidity Proposals, and regional banks with balance sheets composed primarily of business and consumer loans and deposits appear to be the least liquid. Yet, at the height of the financial crisis, broker-dealers were reportedly looking to partner with banks to have access to stable deposit balances, not the other way around. No liquidity ratio should punish a strong deposit base. Given the treatment of core deposits in the Liquidity Proposal, banks will have to shrink their balance sheets and/or shift to expensive long term funding. Either or both of these actions will decrease deposit rates on liquid core consumer deposits, decrease the availability of credit and increase the cost of credit.

Deposits of governmental entities are treated as running off at a 100% level if they are unsecured. The punitive treatment of these deposits will make it very difficult for banks to accept deposits from governmental entities and pay an interest rate that is commensurate with their actual liquidity value. This could have the result of driving the cash of public sector entities from the banking system, and into other, potentially riskier, alternatives.

The categorization of deposits into "stable" and "less stable" in the Liquidity Proposals does not adequately recognize the value and role of deposit insurance. Indeed, the Liquidity Proposal specifically states that deposit insurance is not sufficient to make a deposit "stable". The federal deposit insurance program in the United States is a linchpin of a system that assures depositors of the safety of their insured deposits, and thereby increases the long-term liquidity value of the deposits. The deposit insurance program, which is funded by fees paid by banks, has withstood the test of time and numerous

crises, and proved its worth once again in the most recent financial crisis. Consumers in the U.S. are very familiar with the Federal Deposit Insurance Corporation and its role in ensuring the safety of deposits in the event of a bank failure. Many U.S. banks including Fifth Third experienced an increase in insured deposits during the financial crisis, not a decrease. In the United States, a primary categorization of deposits should be into those that are "insured", and those that are "non-insured", with further categorization of non-insured deposits based on the type of deposit and customer. The current categorization of deposits in the Liquidity Proposal based on attributes such as direct deposit relationships is overly cumbersome and should not be used as the primary determinant of the liquidity value of the deposit. Fifth Third strongly recommends that deposit runoff assumptions be carefully calibrated based on experience in the recent financial crisis, and that insured deposits be given a runoff factor of zero.

Secured Funding Runoff

The treatment of the maturities of secured borrowings is unduly punitive and ambiguous, as currently written. Within the LCR, it is indicated that secured funding backed by assets other than government debt is assumed to runoff at 100%. Maturities of secured funding backed by other assets are not treated as generating their full liquidity capacity at maturity. This does not conform with actual practice given the ability for secured counterparties to revisit collateralization in situations where the collateral value is deteriorating prior to maturity. Moreover, asset values are subject to a haircut in determining their collateral value. The treatment of maturity of secured borrowings is an additional penalty on asset values and could limit banks' desire to fund these assets through usable and economical sources, resulting in the need to increase rates to make lending economical, thus reducing the availability of credit in the system and increasing its pricing. Fifth Third recommends allowing these maturities to generate full capacity from a liquidity perspective in calculating the LCR. The NSFR is ambiguous as to the treatment of secured funding maturing within one year. Since unsecured maturities are given a 50% factor it would seem to be logical for secured maturities to be given a factor of greater than 50% given the nature of the borrowing.

Undrawn Commitments

The Liquidity Proposal's assumptions of full draws on currently undrawn commitments are not supported by actual observations during the recent crisis, nor in any other crisis. During the recent turmoil, draws on commitments declined as opposed to increased. Borrowers do not generally make uneconomical decisions such as borrowing against their lines if the money is not needed to support their businesses. In addition, the funds generated from these draws end up within the banking system and the cash does not disappear. Assuming a 100% draw on all facilities issued to financial and public sector entities and on all liquidity facilities appears to be extreme and not based on empirical data. The result of these assumptions is that banks will have to increase the cost of committed lines or reduce their availability. Fifth Third agrees that an assumption of some increase in committed line draws in a stressed situation is prudent, but recommends calibrating the assumption to historical experience.

Net Stable Funding Ratio (NSFR)

The NSFR seeks to ensure that long-term or less liquid assets are adequately funded by long-term sources of funds. However, given the 12-month horizon of this ratio, the lack of consideration of the liquidity value of assets introduces flaws into this ratio. Over a 12-month period, banks have a number of tools to use in managing and creating liquidity, including deleveraging, selling assets and attracting deposits. By not recognizing these tools within a holistic liquidity management framework, the NSFR will force banks to change the composition of their balance sheet in ways that will be detrimental to their core function of providing credit efficiently to the real economy, as outlined earlier. In addition, the term funding requirements that the NSFR imposes are in some instances extreme, such as a 100% requirement for agency securities.

Deposit Weightings in NSFR

As a related matter, the deposit weightings within the NSFR are severely punitive and make transaction deposits and savings accounts less desirable for banks. As a result, banks will be forced to favor term deposits over deposits without a defined maturity, which reduces customer access to liquidity. This also goes against long-standing and established policy that banks allow customers to choose their deposit maturity preferences while the government acts as the lender of last resort in times of uncertainty. This policy allows banks to have the time to generate cash from the loans on their balance sheet without destroying the value of the company. This policy also eliminates the need for banks to only make demand loans in order to meet their liquidity obligations, which could set up a vicious cycle of calls on loans and consequent defaults, as occurred in the Great Depression. Fifth Third recommends that the NSFR apply only to activities outside of core lending and deposit gathering activities, which is the primary function of banks.

Other Considerations

If the Liquidity Proposal were put into place as currently written, the banking system would require substantial long-term debt issuance to fund the acquisition of highly liquid assets. Analyses by investment banking firms suggest that the term debt issuance shortfall for U.S. banks under these proposals could be in the order of $1-2 trillion, which is substantially greater than the peak single year issuance of approximately $650 billion. The significant amount of supply from financial firms will result in an increase in the cost of debt to incent investors to purchase the securities, in addition to increasing the cost of debt for non-financial firms, as they are forced to compete with more attractive returns from financial firms.

In a systemic crisis, the banking system as a whole is unlikely to lose deposits. Similarly, if all banks had their committed lines drawn by their customers, where would the money go? In the event of a crisis, all banks will be expected to sell the same government securities or use them to generate funding. All market participants will want to be on the same side of the trade, while some will have to be buyers for the liquidity value of securities to be realized. This function in the U.S. belongs to the Federal Reserve

Discount Window in its capacity as lender of last resort and market stabilizer. If this logic were accepted in this instance, it would be illogical not to allow other assets which can be pledged to the Discount Window to be included as liquid assets (with appropriate haircuts) for the LCR and assign them a lower liquidity factor in the NSFR.

Capital Proposal

The major features of the Capital Proposal about which Fifth Third has concerns are the following:

- Elimination of hybrid capital securities as a (limited) form of Tier 1 capital
- Deduction of the value of Mortgage Servicing Rights (MSRs) from common equity
- Eliminating the adjustment made to Tier 1 capital for unrealized gains and losses on Available for Sale (AFS) securities
- Full deduction of deferred tax assets (DTA) from Tier 1 Common Equity

<u>Criteria for Tier 1 Additional Going Concern Capital</u>

Among the Criteria for inclusion in Tier 1 Additional Going Concern Capital, there are several criteria that would eliminate Trust Preferred Securities (TPS) from Tier 1 capital. The market price reaction of TPS during the financial crisis clearly indicated that investors expected to take losses on these securities in the event of the insolvency of the issuing institution or that issuers would begin deferring interest payments. Banks, through repurchases and exchanges, were able to turn TPS into common equity at discounts reflecting those expected losses. In addition, banks took advantage of the coupon deferral provisions in these securities to defer coupons and preserve capital.

An important benefit of TPS is the ability to have a portion of Tier 1 capital be comprised of tax efficient securities that serve to reduce the overall cost of capital for banks. In the U.S., the coupons paid on non-cumulative perpetual preferred securities are not tax-deductible, and therefore elimination of credit for TPS in Tier 1 capital will increase tax and competitive differences across jurisdictions, and will not help the stated goals of international symmetry with respect to these standards. Tax deductibility in and of itself should not cause an instrument to be disqualified from serving as capital.

Fifth Third agrees that common equity should be the predominant form of capital within Tier 1. However, while TPS clearly do not have the loss absorption capacity of common equity, they do have a role to play in a well designed Tier 1 capital structure. Hence, Fifth Third recommends that the criteria for Tier 1 Capital securities be modified to allow TPS to be included in Tier 1 Capital up to a pre-determined limit as is currently the case. If the final rules do not include TPS as an approved component of Tier 1 capital, Fifth Third would support grandfathering of existing regulatory capital instruments issued prior to the capital rules' being finalized, and recommends that these instruments be grandfathered to their maturity date.

Deduction of Goodwill and Other Intangibles from Common Equity

Fifth Third is in agreement with the principle that there should be limits on the extent to which intangible items are included in Common Equity. However, Fifth Third does not agree with the full deduction of MSRs from equity. MSRs have significant economic value, are readily marketable, and are carried on the balance sheet at mark-to-market values. Many U.S. banks actively hedge changes in the economic value of their MSR assets. Given that MSRs (and other types of servicing assets) have economic value and that there is a market for these assets, there does not appear to be any reason to deduct their value from Common Equity beyond the current deductions in the U.S. Deducting the value of servicing rights could have significant ramifications for the U.S. housing market, including increasing the cost of mortgage lending and servicing for banks, a decreased appetite for banks to engage in mortgage lending due to lower profitability, and a consequent increase in equilibrium mortgage rates. Fifth Third recommends that MSRs continue to be included in Common Equity in the manner in which they are currently included in capital in the U.S., namely a 10% deduction to account for the market volatility of the asset and a 100% risk weighting of the asset.

Deduction of Deferred Tax Assets (DTA)

The Capital Proposal contemplates the full elimination of DTAs from equity. DTAs have value in that they permit the institution to avoid outgoing payments in the form of taxes against its primary form of capital generation, which are earnings. The value of the DTAs does permit institutions to preserve capital. Fifth Third recognizes that inclusion of an unlimited amount of DTAs is not prudent. A more appropriate solution would be to allow DTAs in a limited fashion as is currently the case with U.S. capital rules.

Deductions for Unrealized Gains and Losses

The Capital Proposal does not allow unrealized gains or losses in the Available for Sale (AFS) investment securities portfolios to be backed out of Common Equity (as is currently done in the calculation of U.S. Tier 1 capital). Unrealized gains and losses do not take into account an institution's ability to hold a security to maturity. Unrealized gains and losses on fixed income securities, particularly on securities issued by governments and government-backed agencies are often the result of movement in interest rates, not changes in credit quality. By not eliminating gains and losses from equity, the result will be a significantly increased amount of capital volatility attributable to purely temporary conditions. This problem would be exacerbated by the Liquidity Proposal. By forcing a bank to hold additional securities for a liquidity portfolio, this proposal could significantly hamper banks' capital positions should the securities lose value, even if only temporarily, as a result of an increase in interest rates. U.S. accounting standards already require banks to recognize unrealized losses on securities where these are determined to be attributable to other than temporary impairment (OTTI). Fifth Third supports continuation of the current treatment of unrealized gains and losses in the calculation of Tier 1 capital in the U.S.A. in conjunction with the U.S. GAAP treatment of currently recognizing through income (and hence in capital) forecast losses

that are deemed to be other than temporary. An alternative recommendation would be to only have the gain or loss associated with government securities be eliminated from the Tier 1 Common Equity capital calculation.

Minority Interest in Financial Institutions

The Capital Proposal states that minority interest would not be included in the common equity component of Tier 1. Fifth Third recommends that the Committee clarify this proposal. In the U.S., for example, minority interest is not currently included in common equity. Rather, depending on the nature of the minority interest, certain such investments may be included in Tier 1, subject to quantitative limits. While not being able to support the loss absorption for the company as a whole, minority interests do provide for loss absorption in a portion of the business. In addition, the creation of minority interest can be the result of acquiring businesses which assist significantly in the generation of capital through earnings, thus enabling the company to perform better in a stressed environment. Accordingly, Fifth Third recommends clarification that the proposal does not contemplate any change to the treatment of minority interest in jurisdictions where minority interest is currently includible in Tier 1, but not as part of common equity.

Loan Loss Reserves

Loan loss reserves (LLRs) would not be included in Tier 2 capital. LLRs clearly have the ability to help offset losses and are in effect set aside to provide for just this occurrence. If loan loss reserves were built for loss absorption, earnings would fall to the bottom line and into retained earnings, and would receive full capital credit. Fifth Third is of the opinion that limited inclusion of loan loss reserves in Tier 2 similar to current treatment in the U.S.A. would be appropriate.

Leverage Ratio

Unconditionally cancellable facilities will be included in the leverage ratio denominator at 100% of the amount of the facility. This treatment is inappropriate as banks can unilaterally cancel the lines and eliminate the potential exposure, and in fact, in the U.S.A. during the financial crisis, banks did lower credit card lines substantially. Moreover, experience with uncommitted lines during the financial crisis demonstrates that the vast majority of lines were not drawn upon and converted into actual exposure.

Under the proposal, netting of derivatives and repo style transactions will not be permitted in the calculation of the denominator of the leverage ratio. This would aggregate the notional values of derivative volumes in the denominator for leverage calculations. This would not take into account "back-to-back" activities that result in minimal net exposure, and would greatly overstate the amount of leverage an institution is actually taking. This could result in a lack of hedging, and subsequent increases of other risk types in order to minimize the leverage ratio effect. It could also have the unintended consequence of motivating an institution to take on addition derivative risk since the actual amount of risk inherent within the derivative portfolio is not taken into

account. Derivatives should be included in the leverage ratio only on a netted mark-to-market basis as the gross non-netted amounts drastically overstate true exposure.

Other issues which should be considered with respect to the Capital Proposal:

- Issue a revised Capital Proposal after the QIS is completed, including specific targets for the new capital ratios, and ask for comments on the revised proposal. This will ensure that the global financial community has a chance to review and react to the specifics of the revised proposal.
- The resulting shortfall of equity generated by the proposal could result in an inability to attract investors to supply the required capital.
- With the interrelation of liquidity and capital, a liquidity portfolio of liquid assets should not be a detriment to capital in the same way that a loan, or a derivative would be. Therefore, liquid and unencumbered securities should be excluded from the denominator of capital and leverage ratios.

Conclusion

In summary, Fifth Third supports the Committee's objective of increasing the resilience of the global financial system. However, given the far-reaching scope and impact of the Capital and Liquidity Proposals, Fifth Third urges the Committee to err on the side of fostering more discussion and seeking more input, both qualitative and quantitative, on the Proposals. Fifth Third also asks that the Committee publish revised drafts of the Proposals and permit comment on those drafts before finalizing the rules.

Fifth Third Bancorp again thanks the Committee for the opportunity to comment on the proposals, and welcomes dialogue around its comments. If you have any questions or comments regarding the comments we have submitted, please do not hesitate to contact me directly at 513-534-8879.

Sincerely,

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