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Secretariat Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002
Basel, Switzerland

baselcommittee@bis.org

Re: Consultative Document: *Strengthening the resilience of the banking sector*

Ladies and Gentlemen:

KeyCorp is a large regional bank-based financial services company in the U.S., with assets of approximately $95 billion. Key companies provide investment management, retail and commercial banking, consumer finance, and investment banking products and services to individuals and companies throughout the United States and, for certain businesses, internationally.

KeyCorp appreciates the opportunity to submit this letter of comment on the capital section of the Consultative Document, *Strengthening the resilience of the banking sector* (the "Consultative Document" or "CD") published December 2009 by the Basel Committee on Banking Supervision (the "Committee"). We strongly agree with the Committee's stated objective of "improving the banking sector's ability to absorb shocks arising from financial and economic stress, whatever the source, thus reducing the risk of spillover from the financial sector to the real economy." We agree that the recent financial crisis has highlighted certain vulnerabilities in the global regulatory framework and that better and stronger regulation is needed to ensure a more resilient banking system. We look forward to working with the Committee and our national regulators to address these issues.

We fully support the Committee's key objectives and a number of the proposals included in the Consultative Document and support their eventual implementation. However, we believe that certain other proposals should be reconsidered, revised, or withdrawn because they may not achieve their stated objectives, are redundant or duplicative in nature, or could have significant unintended and undesired consequences.

Requiring financial institutions to hold excessive capital can be as disruptive as requiring too little capital. Given the severity and broad scope of the proposal we are most concerned that, if implemented, it would have severe negative macroeconomic consequences. We also believe the proposed rules would, in combination with the liquidity proposal, have

unintended or unforeseen consequences as financial institutions seek alternative ways to conduct profitable business by enhancing the risk-return trade-off while striving to use less regulatory capital. Requiring the banking system to hold excessive amounts of capital may also give rise to a new generation of unregulated non-bank financial service providers.

Our analysis of the key issues that we deemed appropriate for comment are set forth below. We hope you find our comments helpful and constructive.

I. Comments on Proposed Phase-Out of Hybrid Instruments from Tier 1 Capital

> 75. To be included in Tier 1, instruments will need to be sufficiently loss absorbent on a going-concern basis.
> 76. To be considered loss absorbent on a going concern basis, all instruments included in Tier 1 will, among other things, need to be subordinated, have fully discretionary noncumulative dividends or coupons and neither have a maturity date nor an incentive to redeem. In addition, as part of the impact assessment, the Committee will consider the appropriate treatment in the non-predominant element of Tier 1 capital of instruments which have tax deductible coupons.

KeyCorp strongly encourages the Committee to reconsider its proposal to eliminate the current Tier 1-qualifying trust preferred structure, a hybrid structure comprised of debt and equity characteristics, commonly used by banks in the U.S to fulfill a portion of their Tier 1 capital needs. Much of the Tier 1 issuance by U.S. banks in recent years has utilized structures that do contain substantial loss-absorbing provisions --- they are frequently non-cumulative, contain dividend deferral covenants and are long-dated (30 years or longer). We believe that U.S. style instruments did demonstrate loss-absorption capacity during the recent financial crisis, and they did so at a lower all-in cost to the banks than common equity. During the financial crisis, a number of U.S. bank trust preferred instruments traded at a deep discount to par value, and a number of security holders suffered losses. In the U.S. several SCAP banks exchanged outstanding trust preferred securities with their holders for new common equity, on both a direct and indirect basis, at prices that resulted in significant losses for the holders of the trust preferred securities.

In the United States, regulatory approval is required in order to execute on an early redemption (exercise of call option) of trust preferred securities. This requirement helps to add substance to the notion that these instruments are effectively non-callable in a crisis and are true capital. Also, these instruments were viewed as capital by investors and at least arguably allowed for the raising of additional common equity when it was needed.

Maintaining these instruments in place would also ease the significant demand pressure on the equity markets that is anticipated to occur following implementation of the CD. Use of such structures also eases the burden on banks that need to build additional capital cushion.

If the decision is made to ultimately eliminate such hybrid capital structures, we strongly urge a long transition period of up to 10 years, to allow for a smooth, orderly build-up of capital from retained earnings that can be used to retire these instruments in an orderly fashion without creating a rush to the capital markets by many institutions all at once.

II. Comments on Proposed Revisions to the Definition of Common Equity

1. Deferred Tax Assets

> Deferred tax assets
> Deferred tax assets which rely on future profitability of the bank to be realized should be deducted from the Common Equity component of Tier 1.
> 99. ... Typically, such amounts will only be realized through the reduction in future tax payments if the bank makes profits in the year that the loss is recognized for tax purposes. The proposal addresses the concern that undue reliance on these assets is not appropriate for prudential purposes, as they may provide no protection to depositors or governmental deposit insurance funds in insolvency and can be suddenly written off in a period of stress.

We believe that deferred tax assets (DTAs) should be eligible to be included in core Tier 1 on a limited basis and propose that the Committee permit national regulators discretion in their treatment of DTAs for capital purposes to best capture the differences between tax and accounting treatment of certain revenue and expense items at the national level. Current U.S. regulations state that the:

"..... amount of deferred-tax assets that may be included in bank Tier 1 capital should be the lesser of:

(i.) The amount of deferred-tax assets that the bank is expected to realize within one year of the calendar quarter-end date, based on its projections of future taxable income for that year, or

(ii.) 10 percent of tier 1 capital.

The reported amount of deferred-tax assets, (net of any valuation allowance for deferred-tax assets that is in excess of the lesser of these two amounts), is to be deducted from a banking organization's core capital elements in determining Tier 1 capital."

We believe that even the current U.S. treatment of DTAs is unduly conservative. A more balanced approach would distinguish between DTAs associated with the timing differences between GAAP and tax accounting treatment in the recognition of certain revenue and expense items, and DTAs that are the result of operating losses and dependent upon future taxable income. This approach would assign value to that portion of the DTA balance that is utilizable in the near-term. By only assigning value to that portion of the DTA balance that is utilizable over the following 12 months, it remains a very conservative measure. This approach also "dampens down" the procyclical nature of the DTA impact. DTAs typically become a capital issue when a bank recognizes significant provision expense and is experiencing a reduction in its capital levels. By reducing the impact of the DTA charge to Tier 1, the institution may be able to avoid a capital-raising exercise at the point in time when capital will be at its most expensive.

2. Disallowed Mortgage Servicing Rights and Purchased Credit Card Receivables

> 97. The proposed deduction addresses the high degree of uncertainty that intangible assets would have a positive realizable value in periods of stress or insolvency. It is also necessary for comparability purposes and, in the case of goodwill, to avoid giving acquisitive banks a capital advantage over banks with the same real assets and liabilities which have grown organically.

We believe that mortgage servicing rights are intangible assets that have a reliable revenue stream.

These assets can be monetized in a stress scenario. As evidenced during the recent crisis, valuations for MSRs were maintained and thus, we believe that these assets should be included in Tier 1 equity in accordance with existing standards. For example, MSRs of many Commercial Real Estate portfolios have proven to have very stable balances, carry no residual credit risk and no material prepayment risk. These can be very different from residential mortgage portfolio servicing rights, primarily because of their shorter duration. We recommend that the Committee consider allowing national jurisdictions to establish appropriate treatment of MSRs, as the relative importance of this asset class varies greatly across jurisdictions.

3. Unrealized Gains and Losses Recognized on the Balance Sheet

> 96. The proposal addresses concerns that the existing policy adopted in certain jurisdictions of filtering out certain unrealized losses has undermined confidence in Tier 1 capital. It helps ensure that the Common Equity component of Tier 1 is fully available to absorb losses (both realized and unrealized).

We believe that unrealized gains and losses should not be deducted from capital purely on the basis of market valuation driven largely by changes in interest rates as opposed to changes in credit risk.

Under U.S. GAAP, unrecognized changes in the value of a financial institution's investment portfolio that are classified as "Available for Sale" (AFS) are recorded through equity in accumulated other comprehensive income (AOCI), rather than be treated as income or expense for income statement purposes. Under current U.S. regulatory practice, these gains and losses are not included in the calculation of common equity capital. This treatment has served to allow financial institutions to avoid potentially excessive capital volatility and we believe that this treatment should be permitted to continue, or that national regulators determine appropriate treatment on a jurisdiction-by-jurisdiction basis.

Many diversified financial institutions use the investment portfolio to manage variability in funding levels and manage interest rate risk. Changes in the value of this portfolio occur due to changes in interest rates, and there is no off-setting change to equity for the value of the bank's liabilities, for which the securities often act as a hedge. Therefore, common equity capital is currently either adversely or advantageously affected by a one-sided mark in the investment securities portfolio.

The majority of unrealized losses related to a portfolio of high quality (AAA-rated) fixed income securities are due to changes in interest rates. If all unrealized losses on the AFS portfolio are included in Tier 1 capital, then in a rising rate environment, temporary declines in value due to changes in rates will depress the bank's regulatory capital levels even when the bank has no intention of selling any of the securities.

If unrealized losses are deducted from regulatory capital, banks will have to incorporate this capital impact into the portfolio structuring and investment decision, and may, at inopportune times, be forced to make short-term investment decisions that are detrimental to the long-term health of the organization, such as selling securities in a rising rate environment and recognizing a charge to earnings and capital to avoid additional future anticipated rate increases, and buying shorter duration securities.

Under U.S. GAAP, this detrimental impact to capital from interest rates is compounded by the deferred tax asset (DTA) treatment, and under the CD such treatment would be magnified. Our capital stress testing indicates that in a rising rate environment, a fixed rate investment security portfolio's unrecognized loss will grow, and the deferred tax asset related to the loss increases, compounding the adverse impact to capital if the bank is in a deferred tax asset position. This effect may force a bank to raise capital at a time of rising interest rates to alleviate what may prove to be a short-term weakness in capital.

Given this linkage of interest rates to changes in capital, it is clear that Tier 1 capital will become more volatile for a majority of financial institutions if this provision is adopted. We do not understand how such treatment would achieve the Committee's stated objective, as expressed in Paragraph 96, of increasing confidence in the Tier 1 capital measure. In fact, we would anticipate that increased volatility associated with interest rate movements would lower confidence in Tier 1 capital; make projections of future Tier 1 capital levels less accurate; require banks to maintain a larger capital cushion to protect against rising interest rates, and change investment portfolio management practices to accommodate the risk associated with rising interest rates, and increase the procyclical nature of the regulations. In light of the growing need for significant demand for U.S. government and other sovereign debt from bank investment portfolios, this provision in the capital requirements could prove to be counter-productive for the global economic environment.

III. Comments on the Proposed Definition of the Leverage Ratio

The U.S. regulatory system has long utilized a straightforward, easy-to-calculate Tier 1 leverage ratio measure as an integral part of its capital regime. It has been long been viewed by many in the industry as a stop-gap designed to close a regulatory loophole, serving primarily to prevent an institution from creating significant balance sheet leverage using low risk-weighted assets. It is calculated by dividing Tier 1 Capital by quarterly average assets less goodwill and certain other items.

We believe that the Committee's proposal to establish a Tier 1 leverage ratio needs should be reconsidered. As it is currently proposed, the ratio does not distinguish assets by degree of risk; as such it may serve to encourage more risk-taking as institutions' strive to cover the cost of the capital required to maintain the ratio.

The denominator of the ratio for all but the simplest of financial institutions would be potentially several times larger than their risk-weighted assets and GAAP asset totals. To ensure appropriate calibration with other regulatory ratios, and minimize the risk-incentive aspects of the ratio, the resulting regulatory floor would have to be set at such a low level as to be meaningless for many institutions.

If the Committee chooses to proceed with the leverage ratio, we would recommend several modifications to the proposed definition to exclude the following items in the denominator: 1). Legally enforceable netting arrangements; 2). Written credit derivatives exposures that are offset with purchased options; and, 3). Unconditionally Cancelable Facilities.

1. Legally Enforceable Netting Arrangements

206. The design of a leverage ratio requires a definition of capital (the capital measure) and a definition of total exposure (the total exposure or assets measure). ....netting is not allowed (this applies to both regulatory and accounting netting for derivatives, repo style transactions and the netting of loans and deposits);

We believe that a more balanced approach would be to align the netting of the derivatives book with current U.S. GAAP practice under FASB Accounting Interpretation No. 39-1.

The Proposal's "no netting" approach to calculate derivative and repo exposures in the denominator of the leverage ratio is overly punitive and would overstate a company's leverage - a balanced approach provides a more realistic measure of leverage.

Current practice under U.S. GAAP permits a reporting bank that is party to a master netting arrangement to offset fair value amounts recognized for the right to reclaim cash collateral against any obligations to return cash collateral for derivative contracts that have been offset under the same master netting arrangement using standard agreements created by the International Swaps and Derivatives Association (ISDA). Such agreements have been used for several years and have been demonstrated to be reliable and enforceable in bankruptcy and similar proceedings. This rule, if implemented, could discourage prudent risk management practices for these types of contracts by removing the capital savings that come from the netting arrangement.

2. Written Credit Derivatives Exposures are not offset by Purchased Options

Credit derivatives 230. Where a bank sells protection using a credit derivative, its exposure is effectively the same as providing a guarantee and therefore a 100% credit conversion factor will be applied. That is, the notional value of written credit derivatives will be included in the measure of exposure for the purposes of the leverage ratio.

231. Consistent with a gross measure of exposure and the treatment of credit risk mitigation for on-balance sheet items, bought credit protection will not be permitted to be netted off against written credit protection.

We believe that the Proposal's current approach to not permit credit protection purchased to be used to offset credit protection written is overly punitive and does not reflect the true leverage position of the company.

The Committee's desired end -- to constrain the build-up of excessive leverage in the banking system, which compromises loss absorbency--, will be negated by a reduction in the use of such risk mitigation techniques.

Many banks use credit default swaps (CDS) to mitigate credit risk exposure inherent in the loan book. Credit risk is defined as the risk of loss arising from an obligor's inability or failure to meet contractual payment or performance terms.

Credit default swaps enable banks to transfer a portion of the credit risk associated with a particular extension of credit to a third party, and to manage portfolio concentration and correlation risks. Occasionally, banks also provide credit protection to other lenders through the sale of credit default swaps. In the normal course of business, there are occasions when credit protection written on a loan facility is no longer needed. Rather than terminating the CDS, it is often much more cost effective to book an offsetting trade and write protection on the same credit to the original or another counterparty. This transaction negates the original protection produced by the original swap. Although market and counterparty exposures may remain, these risks are captured in the market risk-based capital rules. To include written credit exposure at 100% of notional amount in the leverage ratio would likely overstate the true residual exposure from such offsetting transactions. We believe that the final proposal should permit protection purchased to offset protection written on an underlying name and not exclude credit derivatives from the derivatives exposure totals.

3. The denominator of the Leverage Ratio includes unconditionally cancelable commitments using a 100% conversion factor

4. Off-balance sheet items (excluding derivatives)

232. This discussion relates to off-balance sheet (OBS) items in paragraphs 82-83, (including 83(i)), 84(i-iii), 85-86, and 88-89) of the Basel II framework. These include commitments (including liquidity facilities), unconditionally cancelable commitments, direct credit substitutes, acceptances, standby letters of credit, trade letters of credit, failed transactions and unsettled securities. The treatment of the items included in 83(ii) and 84, i.e. "repos" and securities financing transactions is addressed above.

233. OBS items are a source of potentially significant leverage. The failure to include OBS items in the measure of exposure creates an incentive to shift items off the balance sheet to avoid the leverage ratio constraint. The Committee therefore proposes to include the above BS items using a 100% credit conversion factor. This approach is simple and consistent with the view that OBS items are a significant source of leverage.

We believe that the proposal to include in the denominator of the leverage ratio unconditionally cancelable facilities would be unduly burdensome given banks' unencumbered ability to terminate such exposures at any time.
We also believe that the inclusion of off-balance sheet exposures in the leverage ratio at a blanket 100% credit conversion factor does not appropriately reflect the wide variance in the risks related to these exposures, based either on the risk profile of the exposure or the presence of other risk mitigants.

Many major lending banks in the U.S. have extended a large notional amount of such facilities backed by 1-4 family residential real estate. These facilities, which are quite common in our markets, are unconditionally cancelable, are excluded from the risk-based capital calculations, and should therefore be excluded from the leverage ratio.

Credit risk associated with such credits is small relative to the credit risk embedded in the traditional commercial loan facility that carries a 100% risk weighting or a traditional first lien residential mortgage loan without the cancellation feature that is 50% risk-weighted.

We understand the Committee's concern about potential regulatory arbitrage that can be created by moving certain assets off-balance sheet in order to reduce regulatory capital charges, coupled with the inadequate nature of certain risk transfer mechanisms that may mask the true degree of risk retained by the bank or give rise to actual or implicit recourse to the bank. However, we do not believe the solution to these concerns is to include all off-balance sheet exposures in the leverage ratio at a 100% conversion factor. We believe a more prudent approach would be to adjust the credit conversion factors to more appropriate levels within the already-exiting Basel I risk-based capital framework for application to the Tier 1 and Total capital ratio calculations.

IV. Comments on proposed Capital Buffers

> ….248. Outside of periods of stress, banks should hold buffers of capital above the regulatory minimum. 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…..

We recommend that the Committee revisit the concept of a capital buffer to structure a framework that more flexibly accommodates each bank's unique risk profile.

The CD outlines a proposal to ensure that banks build up capital buffers during periods of non-stress, which can be drawn down as losses are incurred. We support the concept of capital buffers and recognize their important role and benefits in times of stress. We do believe that establishing a single framework of buffers to be employed by all banks is not necessary and could have an adverse impact on a number of institutions. For KeyCorp and other large U.S. banks, capital requirements are carefully and closely monitored through a quarterly capital adequacy and stress test process, which allows for a robust comparison of book and regulatory capital levels against the bank's internal risk assessment. The internal risk assessment is typically referred to as 'economic capital' and is the amount of capital required to cover the risk of unexpected losses over a 1-year forward period. These quarterly

calculations that are specific to Key are much more precise than a single 'one-size-fits-all' buffer calculation can be.

The scenario-based forward-looking stress tests, which typically look at least 2 to 3 years into the future, can be coupled with a series of early-warning trigger ratios established by bank policy, which facilitate a more customized approach for determining what the appropriate capital buffer should be. This is just one of many potential customized ways that regulators in national jurisdictions can assess the adequacy of an institution's capital buffer.

We also encourage the Committee to consider a more flexible approach that employs additional capital components to the buffer calculation, such as some or all of the allowance for loan and lease losses (ALLL) which, through the provision, is a deduction from Tier 1 capital. It is available to absorb credit losses during economic downturns and, in this role, already serves as a 'de facto' capital buffer to a limited degree.

V. Comments on the Grandfathering of Current Issues

> *Grandfathering and transitional provisions*
> 84. Given the significant changes proposed to the definition of capital, the Committee recommends that members consider the possibility of allowing the grandfathering of instruments which have already been issued by banks prior to the publication of this consultative document. The impact assessment will be used to consider recommendations for an appropriate grandfathering period for instruments and an appropriate phase in period for the new capital standards.

Grandfathering should not be linked to call features of securities, as this will disrupt secondary markets. It is more appropriate that grandfathering be time based and cover pre-existing securities and securities issued during this period of transition until the new capital rules are well-defined.

KeyCorp recommends that the Committee consider an extended grandfathering period in order to avoid market disruption and additional unnecessary costs for issuers, especially given the current high cost of capital for banks and the pending requirement for some banks to repay significant government equity investments. If there is little or no grandfathering, the effect will be that investors will anticipate that existing issues will be restructured or bought back. Sophisticated investors will be able to take advantage of this situation to secure excessive trading profits.

In the U.S., this particularly applies to such Tier 1-qualifying instruments as the "trust preferred securities" that have been issued in significant volumes since 1996. Transitioning away from just this one instrument will place a heavy burden on the industry as both redemption and new issuance will be expensive and the volumes will be enormous (to the extent that banks ultimately choose to reduce the equity component, as opposed to the asset side of their balance sheets).

Adequate Transitioning Period to new Capital Definitions, Guideline Ratios, and Leverage Ratios including Grandfathering of Existing Limits

KeyCorp strongly encourages the Committee to consider a long transition period to new capital definitions, guideline ratios and other new regulations.
Some institutions may already be in excess of the new limits proposed for hybrid capital instruments relative to the total composition of Tier 1 and, accordingly, such amount of capital in excess of new limits should also be grandfathered as capital for a reasonable period of time. We would fully anticipate that the results of the current Quantitative Impact Study will be utilized to determine what a smooth transition period for the new guidelines should be.

VI. Comments on the Proposed use of Contingent Capital

Contingent Capital
91. In addition to the Tier 1 and Tier 2 criteria set out in the sections above, the Committee continues to review the role that contingent capital, convertible capital instruments and instruments with write-down features should play in a regulatory capital framework, both in the context of the entry criteria for regulatory capital and their use as buffers over the minimum requirement.

KeyCorp recognizes that the Committee will be reviewing the potential role that contingent capital may play in the future capital structure of banks. We recognize that contingent capital may serve a valuable role as an additional capital buffer for banks. However, we believe that a contingent capital framework could result in additional capital costs for the industry and could serve to incentivize institutions to seek out additional risk in order to cover the additional cost of the contingent capital. We would hope that should contingent capital become a new requirement of the regulatory capital framework appropriate consideration is given to mitigating the incremental cost of such instruments elsewhere within the framework.

Conclusion

KeyCorp supports the Committee's key objectives as outlined in these proposals and will support their eventual implementation. However, we believe that a balanced approach is needed to avoid unintended outcomes, including:

- Significant restrictions in the availability, or increases in the cost of capital
- Lessened credit availability throughout the global financial system
- A shift of banking activities to unregulated non-bank entities

We appreciate the opportunity to comment on the CD and would be pleased to answer any questions that our comments may raise.

Respectfully submitted,

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