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Bank of America

September 10, 2010

VIA E-MAIL: **baselcommittee@bis.org**

Basel Committee on Banking Supervision
Bank for International Settlements
Centralbahnplatz 2
CH-4002 Basel
Switzerland

Re: Basel Committee on Banking Supervision, Consultative Document "*Countercyclical capital buffer proposal*", July 2010

Dear Messrs. and Mmes.:

Bank of America Corporation (together with its affiliates, "Bank of America") appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (the "Committee") Consultative Document entitled "*Countercyclical capital buffer proposal*" published on July 10, 2010 (the "Consultative Document"). Bank of America, with total assets over $2.3 trillion at June 30, 2010 is the sole shareholder of Bank of America, N.A. and Merrill Lynch & Co. Inc., has full-service consumer and commercial operations in 50 states and the District of Columbia. We serve clients in more than 150 countries worldwide. Bank of America provides banking, investing, corporate and investment banking services and financial products to individuals and businesses across the United States of America and around the world.

The unprecedented nature of the recent economic turmoil and its consequences for many financial institutions has illustrated the importance of capital regulation, risk management and liquidity risk management. We remain very supportive of efforts to strengthen and harmonize global capital regulations and promote a more resilient banking sector. We commend the goal of the Committee of improving the banking sector's ability to absorb shocks arising from financial and economic stress as well as reducing the risk and impact to the real economy of these shocks. Many proposals of the Committee contained in the "*Strengthening the Resilience of the Banking Sector*" consultative document published in December of 2009 support and reinforce efforts currently underway to improve risk and capital management capabilities across the industry. We understand that the current Consultative Document addresses macro-prudential objectives established in the December 2009 consultative document concerning protecting the banking sector from periods of excess credit growth.

Bank of America is a member of the International Swaps and Derivatives Association ("ISDA"), the Association for Financial Markets in Europe ("AFME"), the Institute of International Finance ("IIF"), the Risk Management Association ("RMA"), The Clearing House Association and the American Bankers Association ("ABA"), and has participated in the preparation of their comment letters. We are supportive of the joint ISDA/AFME, the IIF, the RMA, The Clearing House and the ABA comment letters. These letters contain detailed responses to many of the individual recommendations listed in the Consultative Document and therefore are not repeated in this letter.

We highlight the most critical areas associated with the Consultative Document below. We ask that the Committee apply focus to the following areas as it works to develop macro-prudential tools to protect the banking sector from periods of excess credit growth:

- De Facto *Minimum Capital Requirements:* The combination of the fixed capital conservation buffer and the countercyclical capital buffer will set *de facto* minimum capital requirements significantly above the intended minimum capital requirement. This would both constrain the availability of credit and increase its cost. The buffer would fail to achieve its purpose of mitigating pro-cyclicality as it would be held at all stages of the cycle.

- *One Size Fits All Application:* As contemplated, the countercyclical buffer would apply uniformly to all credit exposures across regulated banks in each jurisdiction. This broad application imposes penalties on banks with sound risk management and underwriting processes that are not justified. Accordingly, we recommend a Pillar 2 approach that would require primary supervisors to assess the facts and circumstances particular to the banking organization, such as its product mix, underwriting standards and risk management practices, to determine whether a countercyclical buffer is appropriate.

- *Overlap with Pillar 2 Capital Adequacy Assessments:* We recommend capital conservation standards that would require banks to provide updated Pillar 2 capital plans and forecasts to their primary regulators and, in more extreme cases, require regulatory approval for earnings distribution. Inflexible triggers and restrictions cannot accommodate an analysis of a bank's unique financial position.

- *Unclear Interaction with Other Basel III Proposal:* The combined impact and interdependency of the conservation buffer and countercyclical proposals is not yet fully understood. We also recommend that the Committee finalize the remaining Basel III proposals and a sufficient period for comment on their collective impacts and integration with other efforts before considering implementation in isolation. Moreover, we suggest the Committee design a pilot program, as described below, to run in parallel for a period of time to evaluate the effects of the proposed buffer against other changes in capital and liquidity requirements. A fragmented approach to implementation appears to have few benefits, but many risks.

- *Implementation Issues:* The Consultative Document is silent on many important practical issues that will need to be addressed prior to implementation.

We support the notion that banks should build capital buffers that can be drawn down as losses are incurred in a stressed environment. Banks are already establishing buffers designed for their unique circumstances though the Pillar 2 internal capital adequacy assessment processes. We strongly encourage the Committee to refrain from introducing a blunt, additional countercyclical buffer in the context of Pillar 1. In our judgment this requirement would not function in practice as envisioned in the Consultative Document, but rather would be interpreted as a *de facto* minimum capital requirement and would not vary with the cycle (*i.e.*, would not be drawn down in a stress period). We believe capital conservation measures would be more effective under a Pillar 2 approach. This would allow the assessment to focus on the facts and circumstances particular to the earnings, capital and liquidity of the individual firm, consider its governance and risk management practices, and promote proactive dialogue between the firm and its primary supervisors.

***De Facto* Minimum Capital Requirement**

Our primary concern is that the combination of the fixed capital conservation buffer and the countercyclical capital buffer will set *de facto* minimum capital requirements significantly above the intended minimum capital requirement. This would not address the underlying problem of pro-cyclicality that the buffer is designed to counteract and would impose significant increases in the cost of credit that would impact the broader economy.

Bank capital planning processes typically focus on capital requirements over a two to three year horizon. Capital plans consider expected growth, new activities, changes in business mix, risk profile changes, the economic environment, and, finally, expected changes in regulatory requirements. The Consultative Document's proposed buffer, which could be triggered with 12 months notice at the discretion national supervisors, would create an uncertainty that will likely need to be addressed in a bank's capital plan by setting conservative capital targets that presuppose the buffer would become binding during the capital planning horizon.

It is foreseeable, and understandable, that many banking organizations will make a strategic decision to maintain the buffer at all times due to concern that there would likely be a rush to the markets when the buffer is imposed in one or more major jurisdictions. Despite the 12-month horizon, the announcement effect that the countercyclical buffer has been triggered would cause markets, rating agencies and even supervisors to immediately reset expectations to higher capital requirements thereby exacerbating the rush to market. If the need to issue new capital exceeded investor demand, the cost of capital will rise, and may become prohibitive, or in the extreme capital may be unavailable for all but the top tier institutions. Additionally, restrictions on distribution of a bank's earnings could create pressure on the

bank's stock price that would further restrict its access to markets and increase its cost of equity. For these reasons, banks will have strong incentives to hold capital above the maximum buffer requirement during all points of the cycle.

Finally, although the proposal specifies that the buffer would be released at the turning point of the business cycle, and banks would be able to use the capital to absorb losses, it is questionable whether regulators and the broader market would tolerate a decline in capital as economic conditions deteriorate. Rather, we suspect that capital levels that include the buffer would become a permanent part of supervisory and market expectations. Current experience suggests that economic and financial turning points often cannot be determined until well after the time when they actually occur.

These factors would cause banks to maintain the buffer throughout the business cycle. This would constrain the availability and increase the cost of credit. The buffer would fail to achieve its purpose of mitigating pro-cyclicality as it would be held at all stages of the cycle.

One Size Fits All Application

As contemplated, the countercyclical buffer would apply uniformly to all credit exposures across regulated banks in each jurisdiction once it is imposed. This broad application imposes penalties on banks with sound risk management and underwriting processes that are not justified. While the proposal correctly notes that all banks suffer in the correction following periods of excessive aggregate credit growth, we recommend that the protection from excessive credit growth would be much more effective if it was targeted to the specific asset classes and industry sectors that are contributing to the growth.

Banks with prudent risk management processes should not be penalized for the actions of others. Likewise, the capital requirements and cost of credit for particular product classes should not be impacted by excessive credit growth in other product classes. Accordingly, we recommend a Pillar 2 approach that would require primary supervisors to assess the facts and circumstances particular to the banking organization, its products, and other particular facts surrounding periods of excess credit growth.

We are also concerned about the application of the increased capital requirements as a result of the countercyclical buffer only to regulated entities. This would lead to banks being penalized by the actions of non-bank lenders, such as hedge funds, investment firms and other non-bank financial intermediaries, to which the buffer would not apply. The growth of subprime lending was due in significant part to the activities of non-bank lenders outside the scope of banking regulation with weaker underwriting standards, lower capital requirements and misaligned pricing. Since the buffer proposal would have no impact on unregulated entities, higher capital requirements for banks may not be particularly effective in reducing excessive credit and further channel business towards the less regulated sector. We maintain that credit growth is better controlled through industry-wide credit underwriting and risk management requirements. For example, in the United States the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act is expected to increase

standardization of loan underwriting and origination practices across the banking and non-banking sectors. As necessary, regulators should consider requiring higher capital for those banks with weak credit underwriting and risk management.

The Consultative Document recognizes that identifying periods of systemic risk that is caused by excessive private credit growth is difficult. The methodology chosen, which measures the difference between the ratio of private sector credit to gross domestic product, appears to be an imperfect quantitative tool for attempting to measure or identify such periods. The proposed measurement's limitations, combined with the absence of an objective quantitative tool for identifying these periods, suggest that a strong and committed qualitative element should compliment this methodology. However, we likewise remain mindful of the inherent uncertainties that qualitative judgments (which are irreducibly subjective, at least to a degree) entail, and that approaches tethered to the exercise of judgment must be approached with caution. Use of qualitative judgment in these circumstances might be appropriate and inevitable, but may also limit the ability of banking organizations and others to accurately plan for the future.

Overlap with Pillar 2 Capital Adequacy Assessments

Countercyclical capital buffers that respond to national or global periods of excessive credit growth should be anchored in the Pillar 2 internal capital adequacy assessment processes, which allows for a more finely calibrated response that reflects the actual circumstances of the affected institution. Prudent management discipline and effective Pillar 2 processes should require capital management plans that outline responses to a reduction in capital relative to internally assessed and Pillar 1 minimum capital requirements. We recommend capital conservation standards that would require banks to provide updated Pillar 2 capital plans and forecasts to their primary regulators and, in more extreme cases, require regulatory approval for earnings distribution. Inflexible triggers and restrictions cannot accommodate an analysis of a bank's unique financial position and would needlessly put a bank at a competitive disadvantage, risking increased pro-cyclicality and downward pressure on its financial condition.

Unclear Interaction with Other Basel III Proposals

The resiliency proposal in December 2009 established four key objectives to reduce pro-cyclicality and promote countercyclical buffers. These included:

- dampening excess cyclicality in the minimum capital requirement,
- promoting forward looking reserving practices,
- conserving capital in periods of stress, and

- developing macro prudential tools to protect the banking sector form periods of excess credit growth.

The capital conservation and counter-cyclical capital buffer proposal addresses the third and fourth objectives. The combined impact and interdependency of the conservation buffer and countercyclical proposals is not yet fully understood. The proposals for the remaining objectives have not yet been fully developed. The Committee's forward looking provision proposal has not yet been finalized.

Additionally, there are several other efforts such as the Internal Capital Adequacy Assessment Process ("ICAAP") related stress testing and contingent capital that may reduce the need for a specific buffer to dampen the effects of excess credit growth.[1] The Committee should evaluate how the addition of capital requirements to deter excess credit growth integrates with these other methods. For example, a stress test should contemplate severe cyclical downturns, possibly as a result of excess credit growth or asset prices bubbles such as housing, and ensure the bank has sufficient capital resources to meet these conditions. In these circumstances, stress testing shares the same objective of the countercyclical capital buffer.

As a result of Basel III and other regulatory changes, banks will already have substantial increases in capital requirements and liquidity, will have to demonstrate capital adequacy following stress tests through their ICAAP requirements and will have several activities constrained through capital deductions. We request the Committee finalize the remaining proposals and a sufficient period for comment on their collective impacts and integration with other efforts before considering implementation in isolation.

Moreover, we suggest the Committee design, test and evaluate the results of a pilot program prior to requiring full implementation. At the present time, excess credit growth does not appear to present reasonably foreseeable material risks, and accordingly the final shape of a countercyclical capital buffer should benefit from a period of testing and evaluation, similar to that supported by the Committee concerning the net stable funding ratio and leverage ratio. A pilot program could be designed to run in parallel for a reasonable period of time to evaluate the effects of the proposed buffer against other changes in capital and liquidity requirements. This will allow the supervisory community, central bankers and the banking industry to determine how to best configure and implement these measures to mitigate the impact of excess credit growth.

Implementation Issues

While the Consultative Document lays out several high level principles for the establishment and maintenance of the countercyclical buffer concept, it remains silent on important practical issues that will need to be addressed prior to implementation. These include the operational

[1] For example, we note the recently issued Basel Committee on Banking Supervision's Consultative Document entitled "*Proposal to ensure the loss absorbency of regulatory capital at the point of non-viability*", published in August of 2010.

definition of credit exposure, and the methodology for determining geographic location of each exposure.

The definition and calculation of credit exposure is unclear in the proposal. While not specified in explicit terms, it appears to encompass all credit activities at their notional levels. The proposal would benefit from more explicit discussion of the scope and specific calculation methodology for the amount of credit exposure in each jurisdiction. In particular, the Committee should elaborate on the treatment of off balance sheet exposures, counterparty credit risk exposures and credit exposures covered by the market risk rules.

The Consultative Document would arm local bank supervisory authorities with an ability to reduce the supply of credit during periods of perceived excessive credit growth. This power has been conventionally viewed as incidental to monetary policy, rather than a matter for bank regulatory supervision. Accordingly, the Consultative Document could shift the balance between bank regulatory authorities and authorities vested with jurisdiction over monetary policy. It is not presently clear to us that all of the consequences to this proposed adjustment in various jurisdictions are well understood.

Additionally, the location of certain risks from a jurisdictional perspective is not always certain. For example, it is not presently clear if the countercyclical buffer, which is designed to dampen excess credit availability, should focus on the location of the lender, of the borrower, of the use of funds, something else, or some combination of these. Additionally, care should be taken to avoid double counting between host country requirements and the requirements of other jurisdictions. These complexities deserve additional consideration, but are not fully explored in the Consultative Document. In our judgment, clearer guidance is required and banking organizations should not be burdened with obligations to trace uses of funds solely for this purpose.

Summary

Bank of America strongly supports the objective of improving the protection of the banking sector from periods of excessive growth, particularly in light of events during the most recent credit cycle. In doing so, it is important to ensure that the framework of international capital regulation remains sound. We are supportive of the Committee’s efforts to strengthen and harmonize global capital regulations and promote a more resilient banking sector.

Capital conservation measures associated with periods of excessive credit growth should be carefully balanced, and incorporate Pillar 2 strategies, rather than relying exclusively on techniques likely to result in *de facto* higher minimum capital requirements at all points in the credit cycle. Sensible improvements to the banking sector’s ability to absorb shocks arising from financial and economic stress will allow banking organizations to serve better their consumer and commercial clients, and to stand as a reliable source of strength performing core financial intermediation functions for the real economy during all points in future credit cycles.

We would be happy to discuss our views in greater detail or discuss any new ideas the regulatory authorities wish to pursue. In that regard, please contact Paul J. Baalman, Managing Director for Capital Management at (980) 386-4573, or John S. Walter, Managing Director for Risk & Capital Analysis at (415) 913-2706.

Sincerely,

Mark D. Linsz
Treasurer
Bank of America