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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*

Dear Ladies and Gentlemen:

Capital One Financial Corporation ("Capital One")[1] is pleased to submit comments to the Basel Committee on Banking Supervision ("Committee") on the consultative document *Strengthening the resilience of the banking sector* ("CD" or "capital proposal").[2]

The Committee rightly focuses on several key weaknesses in the international financial system, namely the need for additional and higher quality capital that can provide banks with an appropriate loss-absorbing cushion during times of acute stress. We believe the CD outlines areas that are critical to enabling the role banks must play in the normal functioning of the global economy, including: improving the quality of the capital base; ensuring appropriate counterparty credit risk coverage; constraining the build up of excessive leverage; and reducing the procyclical nature of existing rules and regulations.

We agree with the Committee's fundamental premise that "[a] strong and resilient banking system is the foundation for sustainable economic growth"[3] and believe that many of the key issues surrounding the recent crisis have been highlighted in the CD.

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[1] Capital One Financial Corporation (www.capitalone.com) is an international financial services company whose subsidiaries, which include Capital One Bank (Europe) plc., Capital One Bank (Canada Branch), Capital One, N.A., and Capital One Bank (USA), N. A., collectively had $115.8 billion in deposits and $212.0 billion in total managed assets outstanding as of December 31, 2009. Headquartered in McLean, Virginia, USA, Capital One offers a broad spectrum of financial products and services to consumers, small businesses and commercial clients in the U.S., Canada and the UK. A top ten credit card issuer in the UK, Canada and United States and a Fortune 500 company, Capital One trades on the New York Stock Exchange under the symbol "COF" and is included in the S&P 100 index.

[2] Capital One has also submitted a letter dated April 16, 2010 regarding the Committee's consultative document entitled *International framework for liquidity risk, measurement, standards and monitoring.*

[3] CD, paragraph 3.

However, we are concerned that some of the recommendations in the CD have been based on anecdotal evidence rather than empirical studies. As such, we believe that the current proposal could both weaken the banking sector and reduce the amount of capital available in the global economy. In this letter, we will outline our key conceptual concerns with the CD, suggest a modified approach, and provide suggestions for how several specific issues could be addressed more effectively.

Overview

Both the capital proposal and liquidity proposal in the Committee's consultative document entitled *International framework for liquidity risk measurement, standards and monitoring* ("liquidity proposal") appear to have been developed to prevent a once-in-a-generation financial crisis. While elements of these proposals could theoretically each work individually to reduce risk without harming the broader economy, in reality they must function together as part of a cohesive system. Additionally, they have not been proposed in isolation. Several regulatory and legislative proposals currently circulating, together with the Basel amendments, would have a substantial cumulative impact on the global economy.

While we agree with the Committee's concerns about the financial crisis' "massive contraction of liquidity and credit availability,"[4] imposing severe capital and liquidity requirements could itself have significant negative ramifications. First, rigid and overly conservative requirements could constitute a shock to the banking system and produce another financial contraction. Additionally, in order to meet substantially higher capital requirements, banks may choose riskier activities in the pursuit of higher yield.

We are also concerned that the capital proposal, in its current form, would introduce greater volatility in regulatory capital ratios, thus forcing banks to hold even more capital than explicitly required (and presumably deemed optimal) by the Committee and/or national regulators to provide a buffer against this periodic volatility. In order to continue to attract private investment, banks may have to increase the price of lending products so dramatically that economic recovery would stall until equilibrium of credit pricing and availability is reestablished. We also fear that substantial amounts of capital investment could shift to unregulated areas of the financial system that promise higher returns, thus reducing regulatory oversight of certain pockets of financial-related activity.

The CD also appears to disregard standards and customs particular to individual countries, developed over time to enable efficient local commerce. Cross-border differences in public policy goals and tax, accounting, and legal standards could result in an uneven, and potentially harmful, global application of the Basel amendments if they are implemented in their current form. Instead, we urge the Committee to ensure that the final rules reflect the actual risks to which banks are exposed in their particular jurisdiction. National regulators may also need to employ significant discretion when interpreting and implementing these rules for their specific jurisdictions.

[4] CD, paragraph 4.

We believe that capital ratios coupled with the use of scenario-based stress tests, similar to the 2009 Supervisory Capital Assessment Process ("SCAP") in the United States, would prove far more useful in the assessment and regulation of capital standards than reliance on rigid capital ratios alone.[5] While we agree that capital requirements should be higher than they have historically been, we would point to recent history as evidence that a narrow focus on capital ratios as the sole measurement of capital adequacy does not sufficiently protect against risk. Given continued financial innovation, constantly evolving accounting, tax, and legal standards, and important differences among financial institutions, scenario-based stress tests would provide a better perspective of an institution's overall sustainability than would static regulatory requirements alone.

Timing Considerations

Given the concerns discussed herein, we believe that the Committee should take more time to assess the wide-ranging impact of the capital and liquidity proposals. We request that, following the completion of the Quantitative Impact Study ("QIS"), the Committee publish a second document with calibrated requirements, providing banks, regulators, and other key market participants with enough time to evaluate and comment upon a comprehensive proposal. While this would postpone the ultimate adoption of new rules, we believe that the two-year transition period currently contemplated by the CD is too short given the current state of the global economy and projections for near-term improvement.[6]

Additionally, we would urge the Committee to consider carefully the timing of the announcement of any new requirements in light of current economic conditions. There is an acknowledged "announcement effect", where increases in required bank capital levels result in lower analyst ratings and share prices, even before those changes are implemented. For both consumers and businesses, the cumulative impact of the capital proposal would likely mean immediately lower levels of lending and investment by banks, since banks that are unable to raise sufficient capital would have to shrink or consolidate.[7]

Cumulative Impact of Basel and Other Regulatory & Legislative Proposals

We agree with the Committee that capital standards must be strengthened across the international banking industry. However, while individual elements of the capital proposal may be reasonable responses to specific issues, the cumulative impact of the various elements must be considered. We fear that the proposed capital requirements,

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[5] We would also note that, during a recession, not only does demand for credit naturally decline, but even those banks that have ample capital are less likely to extend it given the heightened risk of loss.

[6] As stated in the American Bankers Association letter, p.3. (We also note that the QIS currently reflects historical data through 2009, immediately prior to a major accounting shift in the US, the implementation of FAS 166 / 167. We believe that the Committee should gather data on the first two quarters of 2010 as well in order to understand the significant impact of the proposals with respect to the current accounting rules.)

[7] Ibid, p.3.

taken together, may have dramatic macroeconomic effects across the international community. As stated in the American Bankers Association ("ABA") letter submitted to the Committee on April 15, 2010:

> A precipitous increase in required levels of capital through a much more limited definition of tier 1 capital, the phase-out of hybrid capital instruments, the inclusion of additional assets on banks' balance sheets as a result of recent accounting changes, and the need to maintain buffers in addition to minimum requirements, would be expected to result in a substantial reduction in the ability of banks to perform their core intermediation functions and provide capital to the broader economy through loans, investments, and trading activities...These increased costs and the lower supply of bank intermediation activities will translate into lower levels of domestic and global economic growth.[8]

Given that the QIS is currently underway and calibration has not yet occurred, it is difficult to determine with accuracy how the CD will impact the economy. We do believe, however, that industry reports may provide some general indications. For example, the Boston Consulting Group recently published a report that examined the potential impact of the capital and liquidity proposals on 32 large banks across 12 countries. They found that the banks' Tier 1 ratios would decline by approximately 50 percent and, in order to maintain these ratios in a range of 6-8 percent, they would have to raise between $280 billion and $650 billion of additional capital.[9]

While the capital and liquidity proposals alone are significant, they have not been proposed in isolation. In the United States alone, there is an ongoing legislative and regulatory effort to, among other things, overhaul oversight of the banking system, increase consumer protection, impose new assessments and taxes on financial institutions, and reform securitizations. A holistic view must be taken of the cumulative impact of both the Basel and non-Basel changes. If not, banks may be placed in not simply a difficult position, but an untenable one.

A J.P. Morgan Global Research report published in February 2010 estimated the cumulative impact to banks of several regulatory and legislative proposals, including the Volker Rule, tax regime changes, dynamic provisioning, and Basel capital and liquidity enhancements. The report found that the return on equity for global banks would drop from 13.3% to 5.4% in 2011, thus requiring banks to raise lending costs if they are to retain private investment.[10] According to this report, if banks were to maintain their current level of profitability, pricing on all banking products would need to increase by 33%.[11]

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[8] Ibid, p.2.

[9] Boston Consulting Group, *After the Storm*, February 2010, p.10.

[10] J.P. Morgan Global Research, *Global Banks – Too Big to Fail? Running the Numbers*, February 17, 2010, p.1.

[11] Ibid, p.1.

Faced with insufficient capital ratios, banks would likely either raise more capital to maintain their existing business models or limit the scope of their activities.[12] As such, banks would likely pull back from several of the lower margin, intermediation activities that are required for the functioning of the financial system. For example, banks might limit the extension of credit facilities to their customers if they have to hold significantly more capital against these lines. With banks having less capital to devote to lending or critical investments, the important role they must play in the economy and, at this particular time, the economic recovery, would likely be constrained. We are also concerned that in order to meet substantially higher capital requirements, banks may choose riskier activities in the pursuit of higher yields. If banks do not pursue such higher yields, investment capital, along with the associated financial activities, may move from banks into unregulated sectors of the financial system.

The liquidity proposal would further exacerbate this capital deficit since it creates an unforgiving liquidity-capital cycle. In order to meet the proposed liquidity requirements, banks would have to migrate to more liquid but lower-yielding assets, thus depressing earnings. The JPMorgan report found that in order to meet the required longer-term liquidity coverage ratio (at an assumed premium), the universe of banks included in the study would, in fact, suffer a combined earnings impact of over $13 billion.[13]

Given the concerns above, we strongly advocate greater coordination and harmonization not only across the various international regulatory and legislative proposals, but also between the capital and liquidity proposals in order to prevent detrimental and unintended impacts to the global financial system.

Jurisdictional Differences and Need for Regulator Discretion

We understand the Committee's interest in creating uniform capital rules across countries to prevent competitive inequality and achieve a sound global financial system. However, jurisdictional parity is not achieved by applying the same rules to every jurisdiction when different countries have different policy goals and regulatory structures, including tax, accounting, and legal standards that have been developed over time and are integral to the efficient functioning of national and regional economies. Where such real differences substantively impact capital or liquidity issues, the Committee must consider the idiosyncrasies of the particular country and provide national regulators with needed discretion.

We are particularly concerned with the impact that differences in accounting and tax regimes could have on international competitiveness if the capital proposal is implemented as proposed. For example, while we appreciate the declaration by the Financial Accounting Standards Board ("FASB") and the International Accounting Standards Board ("IASB") of their intent to converge accounting standards by 2015, we remain skeptical that this will occur in any meaningful way within the foreseeable future.

[12] Boston Consulting Group, p.10.

[13] J.P. Morgan Global Research, p.30, Table 20. Note that in this exercise they have assumed a premium coverage level to the Basel III proposal of 100% as they expect markets will demand surplus coverage.

In particular, recent pronouncements by both the FASB and the IASB highlight the key differences in their approach to fair value accounting that will continue to drive significant differences between the balance sheets of U.S. and European banks.[14]

We discuss some of the key jurisdictional differences in greater detail in our Specific Comments section, but will provide a brief overview here:

First, the capital proposal calls for the deduction from common equity of all intangibles, which, according to U.S. generally accepted accounting principles ("GAAP") includes mortgage servicing rights ("MSRs"). MSRs are largely unique to U.S. banks, a function of how the U.S. mortgage markets developed over time, in part, to promote homeownership. While many non-U.S. banks elect to hold mortgages on balance sheet or issue covered bonds that do not give rise to MSRs, U.S. banks often structure and/or sell their originated mortgages into traded securities on a servicing-retained basis.[15] Losing any capital treatment for MSRs could create a disincentive for banks to securitize or sell loans, thus leading to fewer loans in the marketplace and/or higher costs of carry (passed through to consumers) as mortgages remain on banks' balance sheets. Additionally, mortgage loan origination could shift to unregulated finance companies, which we do not believe is the goal of the Committee or in the interest of consumers.

While, under U.S. GAAP, MSRs are accounted for as intangibles, they are fundamentally different from other intangibles like goodwill. MSRs represent contractual rights to receive fee-based compensation in return for managing the servicing activities of residential mortgages or home-equity loans. Additionally, there is an active, liquid market for MSRs, allowing them to be monetized in stress scenarios.

Although we are most familiar with U.S. GAAP intangibles, there may be intangibles in other jurisdictions that deserve similar attention as the MSRs. We generally believe that accounting standards, whether in the U.S. or Europe, are insufficient tools for banking regulators to measure an institution's actual exposures or contractual rights because they fundamentally serve a different purpose. They are designed to enhance transparency to investors and other financial statement users, not to measure contractual rights or exposure to losses for the purposes of determining capital requirements.

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[14] Under U.S. GAAP, financial instruments that suffer other-than-temporary impairment (and which banks do not have an ability and intent to hold to maturity or do not expect to recover the entire amortized cost basis) are required to be held at fair value. As part of IFRS 9, a work-in-progress designed to replace the fair value requirements of IAS 39, the IASB changed its own rules to require fair valuing of financial instruments based not on the intentions for sale or the nature of any impairment but instead on the simplicity of the instrument's features (instruments with "basic loan features" that are managed on a "contractual yield basis" may be held at amortized cost rather than fair valued). While the preference of both accounting boards is to encourage the application of fair value concepts to most assets, differences in these and other details threaten convergence between the two standards.

[15] The 30-year-mortgage is largely unique to the U.S. and was developed to support the policy of home ownership. The long-dated maturity of these loans is a key reason why U.S. banks do not generally keep mortgages on balance sheet.

Second, the CD limits Tier 1 capital to common stock and perpetual instruments with discretionary and non-cumulative distributions. In certain European jurisdictions, such instruments can be issued on a tax-deductible basis, but the same is not true in the U.S. Various forms of hybrid instruments that currently qualify for Tier 1 capital treatment and are tax deductible in the U.S. would not satisfy the proposed Tier 1 capital definition (this includes standard trust preferred securities). Specific regulations on capital structure would also limit the ability of, for example, U.K. banks to issue certain types of hybrids.

The global application of the Committee's capital proposals without due consideration to different accounting, tax, and other legal standards would likely have uneven and possibly unanticipated, negative results. The Committee should ensure that the final capital rules reflect the key differences that exist among countries or expressly provide national regulators with discretion on such matters.

Suggested Approach: Scenario-Based, Bank-Specific Stress Tests

As discussed above, we are concerned about the potential impact of these sweeping and conservative capital proposals to the global economy, particularly the ability of banks to contribute to a sustained economic recovery and long-term economic growth. We therefore believe that while reasonable quantitative requirements are necessary, they should be used in conjunction with scenario-based, bank-specific stress tests, which together would better measure an institution's health than "one-size-fits-all" ratios alone.

Forward-looking stress tests that reflect the ever-shifting nature of tax, accounting, and legal standards and effectively integrate both capital and liquidity positions provide a broader perspective on an institution's overall sustainability than do specific ratio-based regulatory requirements. We believe the success of the SCAP in the United States, which helped restore faith in the U.S. financial system, supports this type of forward-looking supervisory approach.

Through the SCAP, U.S. regulators were able to apply stress scenarios across multiple banks and all lines of business within each bank, which, according to Chairman of the Board of Governors of the Federal Reserve System Ben Bernanke, "allowed a broader analysis of risks than is possible within the traditional supervisory focus on individual institutions."[16] Bernanke also proclaimed that the SCAP "was an enlightening exercise that will improve the toolkit we use to help ensure the safety and soundness not just of individual firms, but of the financial system more broadly."[17]

Systematic stress tests like the SCAP afford regulators a heightened ability to evaluate the capital needs of banks within the context of the broader financial system. As Federal Reserve Board Governor Daniel Tarullo stated in a March 26, 2010 speech, "I believe that the most useful steps toward creating a practical, macroprudential supervisory perspective will be those that connect the firm-specific information and insight gained

[16] Chairman of the Board of Governors of the Federal Reserve System Ben S. Bernanke, at the Federal Reserve Bank of Atlanta 2009 Financial Markets Conference, Jekyll Island, Georgia, May 11, 2009.
[17] *Ibid.*

from traditional microprudential supervision to analysis of systemwide developments and emerging stresses. Here, precisely, is where our SCAP experience has helped lead the way."[18]

The SCAP, along with the capital adequacy program reviews of the top U.S. banks, have advanced the process of evaluating banks on an enhanced supervisory basis, rather than relying solely on capital ratio formulas to determine capital adequacy. Additionally, Basel II banks are already implementing institution-specific capital buffers through the Pillar 2 internal capital assessment process.

In addition to providing regulators with more robust supervisory tools, capital requirements derived in part from forward-looking stress tests would prevent the imposition of "one-size-fits-all" rules across the banking industry. Under the stress-test approach we advocate, certain capital ratios would be used across the industry, but rather than serving as the sole measure of capital adequacy, they would be used in conjunction with scenario-based, bank-specific stress tests.

Specific Comments on the Capital Proposal

We appreciate having had the opportunity to share with the Committee our broader concerns with the capital proposal and to offer potential suggestions on ways to improve current regulation. Before we discuss our detailed comments and suggestions on some of the specific proposals within the CD, we note our agreement with the Committee that Tier 1 capital should include only those elements that can absorb losses while a bank remains a going concern.[19] We have concerns, however, that certain Tier 1 capital requirements in the CD seem to be developed upon the assumption that a bank is going to fail and will not remain a going concern. For example, by disallowing any DTAs dependent on future earnings from capital treatment, the Committee is essentially assuming that banks will have no future income and function as gone concerns.

Para 89: Criteria for inclusion in Tier 1 Additional Going Concern Capital

As discussed above, we encourage the Committee to reconsider the exclusion of certain hybrid securities from Tier 1 capital. The opportunity to utilize cost-effective, tax-advantaged hybrid instruments will be more important than ever for banks as they strengthen their resiliency and build greater capital cushions.

Certain hybrids qualifying as Tier 1 capital in the U.S., like those which are junior subordinated to deposits and senior and subordinated debt and long-dated with the option to defer payments for at least five years, provide a significant cushion against loss and the flexibility to retain rather than distribute capital to investors in times of severe stress. Furthermore, the currently existing U.S. regulatory Tier 1 capital limits for hybrids (*e.g.*, traditional trust preferreds are limited to 15% of Tier 1 capital for internationally active banks), the required regulatory approval for early redemption, and the regulatory

[18] Federal Reserve Governor Daniel K. Tarullo, "Lessons from the Crisis Stress Tests", March 26, 2010.
[19] CD, paragraphs 67, 75 and others.

authority (and issuer ability) to defer hybrid payments all help ensure that these instruments deliver protection for a bank's capital base as a going concern. While it is reasonable, as is done in the U.S., to prohibit substantial increases in required payments either over time or upon the occurrence of specific contingencies (so-called "step-ups"), we otherwise believe hybrids should continue to be eligible as Tier 1 capital within established limits.

Recent experience demonstrates the ability of hybrids to absorb losses as many issuers of trust preferreds opted to defer payments.[20] Additionally, during the financial crisis, as regulators in the U.S. emphasized the need for banks to hold more common equity, many institutions converted or exchanged hybrid capital securities into common stock. U.S. banks exchanged approximately $57B worth of subordinate debt, trust preferreds and preferred stock into common equity[21] at substantial discounts, demonstrating that investors understood and accepted the risk of loss on these instruments. Furthermore, we believe that Paragraph 77 of the CD, which indicates that payments on Tier 1 instruments would be considered a distribution of earnings under the capital conservation buffer proposal, also points to the loss-absorbing features of trust preferreds.

We appreciate concerns raised by market participants that various hybrid securities were downgraded by the credit rating agencies during the recent market disruptions. However, we believe that these downgrades were more reflective of rating agencies recognizing the true risk of loss for investors in such securities than of any shortcoming in the effectiveness of such hybrids as core components of a bank's capital structure. In fact, we believe that such recognition of these instruments' loss absorbing features further substantiates their Tier 1 capital characteristics.

In making its final determination about the future of hybrid instruments and any other changes to the types of instruments that may be considered Tier 1 capital, the Committee should also carefully assess the different tax considerations across jurisdictions. Preferential tax treatment in particular jurisdictions for selected forms of hybrids will be a significant form of competitive inequity among all banks and run contrary to the Committee's goal of creating international capital consistency.

If the Committee decides to proceed with the exclusion of certain hybrid instruments from Tier 1 capital, we agree with its view that this should be done in such a way so as to minimize the impact to currently outstanding hybrids. We would endorse an approach that would grandfather the Tier 1 treatment for all hybrid securities outstanding as of the date that regulators issue final rules for their respective jurisdictions. Given that the top 40 U.S. banks had nearly $110 billion in trust preferreds outstanding at the end of 2009,[22] grandfathering of existing securities is critical so that banks have the appropriate time to

[20]FitchRatings, *Fitch Bank TruPS CDO Default and Deferral Index*, January 2010, pp.1-2: Since 2000, 1,813 banks, thrifts and BHCs have issued $37.6bn of trust preferreds and senior and subordinate debt subsequently purchased by CDOs. 311 banks are deferring payments on trust preferreds in these CDOs.
[21] Barclays Capital data, sourced February 25, 2010.
[22] Barclays Capital data.

realign their capital structures without creating massive dislocations to the availability and cost of capital.

Finally, while we appreciate the Committee's intention to continue to review the role contingent capital could play in a regulatory capital framework, we do not believe that a formal requirement for banks to hold a portion of their capital base in the form of such instruments would avert a future crisis. With the menu of securities currently existing, sufficient market demand may not exist to support an industry-wide requirement for contingent capital in any form that makes economic sense for an issuing bank. As stated by Governor Tarullo during an address to the Council of Institutional Investors, "Despite the work that has been done on contingent proposals, it is not yet clear if there is a viable form of contingent capital that would increase market discipline and provide additional equity capital in times of stress without raising the price of the convertible debt close to common equity levels...for the moment at least, there is no proposal ready for implementation."[23]

We do believe, however, that regulators should support banks in raising loss-absorbing and cost-effective hybrid capital, such as tax-deductible instruments that limit immediate shareholder dilution. Regulators could do so by providing Tier 1 credit for instruments that convert into equity at a bank's option or upon hitting certain triggers. We believe that banks and their regulators could, through the stress testing processes discussed earlier, anticipate an impending capital need and utilize their option to convert these instruments into common stock in advance of the crisis. This conversion would be messaged to the market as a prudent capital management tool that, if used in moderation, could be effectively used by institutions in need of more common stock.

Given the reasons discussed above, including most importantly the capital resiliency of many hybrids, we urge the Committee to permit such hybrids in Tier 1 capital within reasonable limits.

Para 96: No exclusion of unrealized gains or losses recognized on the balance sheet from the Common Equity component of Tier 1

While we understand the Committee's desire to ensure that the common equity component of Tier 1 is fully available to absorb realized and unrealized losses, we have concerns with the proposed requirement to eliminate the exclusion of other comprehensive income ("OCI") gains and losses when calculating regulatory capital ratios.

This proposed change has the potential to create tremendous volatility in capital. For example, between the fourth quarter of 2007 and the fourth quarter of 2008, 20 of the largest commercial banks in the U.S. experienced a $47 billion reduction in accumulated OCI. This negative OCI figure represented 7% of those banks' Tier 1 capital and 0.7% of risk-weighted assets as of the end of 2008. During 2009, these same 20 banks

[23] Federal Reserve Governor Daniel K. Tarullo at the Council of Institutional Investors meeting, April 13, 2010.

experienced positive OCI of $32 billion, representing nearly 5% of Tier 1 capital and 0.5% of risk-weighted assets.[24]

Injecting this type of volatility into the capital calculations runs counter to the Committee's goal of making capital levels more stable and predictable. Under U.S. GAAP, other–than-temporary-impairment due to credit deterioration is recorded in earnings, leaving in OCI only unrealized gains and losses related to changes in interest rates and liquidity risk. We do not believe that liquidity and rate risk movements should impact capital, as they do not reflect changes to the underlying health of a bank under scenarios of normal liquidity.

Swings in OCI and the resulting capital volatility may also force banks to change business practices in ways that would decrease the overall stability of the industry. Banks could be compelled to hold more securities as "held to maturity", where OCI gains and losses are not calculated. However, using a "held to maturity" designation for securities would give banks significantly less flexibility to manage their balance sheets effectively as the economic environment evolves.

Similarly, banks may be compelled to make unfounded changes to their investment portfolio practices (*e.g.*, holding mostly shorter duration floating-rate notes instead of fixed rate bonds) that could make it harder and more expensive for them to manage their overall interest rate risk positions effectively. Most significantly, perhaps, banks would have to hold more capital as a buffer against the risk of market movements, decreasing returns and making the industry less attractive to private investment.

Finally, the inclusion of OCI movements through regulatory capital may increase the risk of market contagion. If security prices declined materially, even banks that bear no risk of realizing a loss could suddenly report capital shortfalls, causing a capital crisis to spread unnecessarily.

The CD's approach is also inappropriate in terms of consistency in the application of fair value accounting. Marking only a single component of the balance sheet to market does not reflect the overall market value of the bank. When interest rates move and affect the market value of securities they also change the market value of related liabilities, but most banks carry such liabilities on the balance sheet at book value and not marked to market.

Given the above concerns regarding capital volatility, potentially damaging changes to business practices, fair value inconsistencies, and the heightened risk of contagion, we believe that OCI gains and losses should continue to be excluded from the measurement of capital.

Para 97: Deduction of Goodwill and other intangibles from the Common Equity <u>component of Tier 1</u>

[24] Source: Credit Suisse and Federal Reserve call reports (FR Y-9C), Consolidated Financial Statements for Bank Holding Companies, Schedule HC-R.

The CD states that intangibles will be deducted from the common equity component of Tier 1 capital which, under U.S. GAAP, includes goodwill, MSRs and purchased credit card receivables. We agree that certain intangible assets such as goodwill cannot be relied on to absorb losses so are appropriately excluded from Tier 1 capital. However, MSRs, which are backed by legal contracts and have real expected cash flows, should be included in Tier 1. Recent experience demonstrates the capital sustaining value of MSRs related to performing, non-exotic mortgage loans as values were maintained and durations extended. Any valuation uncertainties could continue to be addressed appropriately through the application of haircuts rather than through full deduction from common equity.

Additionally, there is an active, liquid market for MSRs related to conventional mortgage loans, allowing them to be monetized in stress scenarios unlike other intangibles. The Federal Deposit Insurance Corporation routinely sells servicing portfolios of failed banks and, recently, even going concern lenders have sold MSRs without selling their entire servicing platforms. In 2007-2009, the servicing rights on nearly $295 billion of mortgage loans related to almost 100 portfolios were sold publicly.[25]

Paras 98-99: Deduction from the Common Equity component of Tier 1 of deferred tax assets which rely on the future profitability of the bank to be realized

We have concerns with the complete exclusion of deferred tax assets ("DTAs") which rely on a bank's future profitability from the common equity component of Tier 1 capital, and would recommend capital treatment at least comparable to that currently permitted under U.S. capital regulations. Since 1992, U.S. GAAP has allowed the balance sheet reporting of DTAs that are dependent on future taxable income. This GAAP standard also sets forth a valuation allowance to account for any uncertainty around the use of DTAs to counteract future tax liability. In the U.S., DTAs dependent upon future taxable income, net of the valuation allowance, are deducted from core capital elements in determining Tier 1 capital *only* to the extent that they exceed the lesser of (i) the amount of those DTAs that the banking organization 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% of Tier 1 capital.

Excluding from the proposed capital definitions *all* DTAs dependent upon future taxable income, as recommended by the Committee, would contribute to the pro-cyclicality of bank capital levels. Additionally, given the volatility implicit in the booking of DTAs, having to deduct these instruments would require banks to maintain substantially larger capital buffers and thus pull back credit from the financial system. Furthermore, excluding from capital DTAs dependent on future taxable income may encourage banks to book less allowance in order to minimize DTA creation, which is contrary to the Committee's goal of increasing loss protection.

[25] Data provided by the MountainView Servicing Group.

If a bank recorded a DTA and then later failed to generate taxable income during the related carryforward period, the DTA would be lost and the bank would have to record a loss. However, banks that are unable to generate taxable income during the carryforward period (which can be many years in duration, depending on jurisdiction) are unlikely to continue to be going concerns throughout that period. Tier 1 capital requirements assume that banks are going concerns and aim to prevent failure, rather than assuming that such banks would be unable to earn any taxable income for a multi-year period.

The September 25, 2009 joint letter of the Clearing House Association and the ABA to U.S. banking regulators investigated whether DTAs have been historically realizable. In the absence of readily available granular data, they examined banks' annual reports and discovered that for those bank holding companies that had net DTAs, current tax expense (reflecting the presence of current taxable income) generally has aggregated to an amount exceeding a prior year's net DTA very quickly – generally within one year.[26] As such, pro-forma forecasting of profitability (and therefore usability of DTAs) should be encouraged in order to more accurately reflect economic realities in capital ratios. Scenario-based stress tests would provide a logical home for such a forecasting exercise.

Additionally, as stated in the Risk Management Association's ("RMA") letter, we do not agree with the Committee's view that DTAs necessarily become useless in a crisis. DTAs may be valuable to the acquirer of a bank that is not generating positive taxable income if the acquirer has positive taxable income. The value of DTAs may prove useful during periods of crisis, as we have recently witnessed, where regulators sometimes require one bank to absorb another in order to avoid additional financial shocks to the markets.

Therefore, given that DTAs have largely been historically realizable, we believe that they should be given considerable capital treatment. We believe that the appropriate level of capital designation may be best determined using pro-forma profitability forecasting within the context of scenario-based stress tests. At the very least, however, we support the current DTA capital treatment as set forth under U.S. capital regulations.

Leverage Ratio

U.S. banks have operated under a leverage ratio for many years. We believe, however, that regulatory reliance on a binding leverage ratio can have significant unintended consequences. We agree with the RMA's assessment that any leverage ratio requirement works at odds with a well-structured risk-based capital requirement. While we understand that the Committee may wish to institute a leverage ratio as a simple backstop against excessive lending, we caution the Committee against setting the leverage ratio at a level where it exceeds and effectively eviscerates the risk-weighted capital requirements. If not, especially in the absence of a strong supervisory, stress-test approach, banks may be encouraged implicitly to engage in riskier activities so as to achieve higher returns.

[26] Available at
http://www.theclearinghouse.org/reference/comment_letters/commentLetterDocs/070228.pdf, pp.5-7.

If the Committee decides to proceed with the leverage requirement, we would propose the use of simple balance sheet measures of leverage that require little further manipulation. Including undrawn credit lines or disallowing the netting of derivative contracts may sometimes be appropriate when developing robust, yet appropriately nuanced risk-weighting frameworks. However, in the context of a leverage ratio, they may inappropriately inflate the denominator well beyond any potential real risk exposure.

Furthermore, we urge the Committee to consider the potential impact of a leverage ratio requirement on specific financial activities whose actual risk may be more properly determined under risk-weighting frameworks and scenario-based stress tests. We are concerned that a binding leverage ratio in the form proposed in the CD could discourage repurchase market and credit card activity[27] as well as the use of master netting agreements and other risk reducing mechanisms. We comment in more detail on the latter two issues below.

We also believe that those assets that are considered highly liquid cash equivalents per the Committee's liquidity proposal should be excluded from the leverage ratio measure of exposure. Otherwise, the interaction between the capital and liquidity proposals could require banks to increase their holdings of low-yielding assets and, at the same time, hold capital against them, thus producing a multiple hit to earnings. Finally, we suggest that the appropriate capital measure for the Committee's leverage ratio is Tier 1 capital. All Tier 1 capital, including both common equity and additional going concern capital, absorbs losses while the bank remains a going concern.

Paras 214-216: Exposure measure: Netting

The CD's proposed measure of exposure for the leverage ratio does not permit netting.[28] However, netting of offsetting exposures should be permitted where there is a right of setoff enforceable at law in the relevant jurisdiction. The presence of contractual agreements (often in the form of master netting agreements) between two counterparties that would permit netting in the event of the default of one of the parties means that a bank would never be required to perform its covered obligations while at the same time not being able to exercise its rights against its counterparty.

We support the Basel II approach that permits netting of exposures in two-way situations as long as the legal documentation that would be used to enforce such provisions is valid and binding on the two counterparties. To disallow netting of exposures in such situations would overstate total exposures and require capital to be held against exposures that, given a master netting agreement, cannot give rise to a contractual loss.

In addition, many offsetting exposures are partially or fully collateralized by high quality assets, often cash collateral. Even in the absence of a master netting agreement, cash collateral posted by a counterparty is available to a bank if the counterparty defaults on

[27] The repurchase market is predicated on the high leverage of highly liquid and secure securities. Large, rarely drawn exposures play a significant role in the credit card space.
[28] CD, paragraph 215.

its obligations. Giving no credit to posted collateral ignores the fact that a bank has physical access to collateral upon counterparty default. Netting should be permitted to the extent that posted collateral, with non-cash collateral subject to reasonable haircuts, is available to a bank if its counterparty defaults.

Furthermore, given the Committee's treatment of central counterparties in the CD's section on risk coverage, some consideration should be made to allow netting of exposures that are offset by an exposure to a central counterparty, not just those offset by an exposure to the same counterparty. The Committee's statement in Paragraph 165 of the CD that "banks' exposures to [central counterparties] generally attract a zero [exposure at default]" is founded on the principle that exchanges and clearinghouses can offset risks across many counterparties simultaneously, reducing counterparty credit risk to the banks who use them. We would expect that central counterparties that comply with forthcoming standards to be issued by the Committee on Payment and Settlement Systems and the International Organization of Securities Commissions could play an important role in banks' risk management activities.

Paras 232-235: Exposure Measure: Off-balance sheet items

The CD requires that various types of undrawn lines be measured using a 100% credit conversion factor.[29] Recent experience suggests that this conversion factor is too high for many types of lines, including unconditionally cancellable credit card lines with which we have significant experience.[30] We note that line utilization increased only slightly during the financial crisis due to a decline in the demand for credit. Additionally, credit card issuers have the ability to cancel lines at any time and have done so actively over the past few years. The combination of lower demand and the ability of issuers to reduce lines to protect their balance sheets makes the proposed conversion factor for these lines unrealistically punitive. As noted by research analyst Meredith Whitney in a recent publication, "From their peak in 2Q08, credit card lines have been cut by over $1.4 trillion. By 2011, we believe another $1.3 trillion will be cut from the system. In other words, since the peak, 30% of unused credit lines have been cut from the lending market and by 2011, we expect over 50% of all unused credit in 2008 to be fully cut from the system."[31]

We would urge, instead, a leverage ratio that more accurately reflects actual exposure. We believe that true exposure at default should be included in the denominator of the leverage ratio; i.e. the entire amount of unsecured, uncancellable lines and a portion of secured, uncancellable lines. However, as discussed above, lines unconditionally

[29] CD, paragraph 233.

[30] Under Basel II, banks that actively monitor the financial conditions of their borrowers may exclude unconditionally cancellable facilities from the exposure at default measure. Conceptually, an open but unconditionally cancellable line represents an offer to extend credit to a borrower, rather than a commitment to do so. For retail banks in the U.S., "open-to-buy" portions of credit card accounts (that is, the difference between credit limit and carried balance) are an important example of such exposures. In addition, certain home equity line of credit accounts are unconditionally cancellable by the lender.

[31] Meredith Whitney Advisory Group LLC, "System on Track for Over 50% Reduction in Credit Lines as Line Reductions Will Be Last Flexible Line of Defense For Issuers," February 24, 2010.

cancellable by contract should not be considered exposures since they may be extinguished by the issuing bank at any time and do not subject banks to a risk of loss that should require the holding of capital.

We understand that the Committee is trying to encourage the building of additional capital so that banks will navigate financial downturns more effectively. However, we believe that the Committee's approach to unconditionally cancellable lines in the liquidity proposal is a much more reasonable reflection of their actual risk. Unconditionally cancellable lines are excluded from the short-term Liquidity Coverage Ratio ("LCR") and at the discretion of national regulators in the long-term Net Stable Funding Ratio. As such, if it is not necessary to have committed short-term liquidity for unconditionally cancellable exposures in order to cover a stress scenario that completely shutters the capital markets, then it should be unnecessary to hold regulatory capital against such exposures. The absence of unconditionally cancellable exposures in the calculation of the LCR reflects the correct assumption that, in a stress event, banks would move immediately to cut cancellable lines to the extent they deem necessary. The leverage ratio should reflect this assumption as well.

The economic impact of including unconditionally cancellable lines in the leverage ratio would be enormous. For many U.S. and international banks, large credit card portfolios feature tens or hundreds of billions of dollars in unconditionally cancellable open lines. Including these lines in the leverage ratio would require these institutions to raise significantly larger amounts of capital, *despite no additional risk of loss being taken.* Banks would likely increase prices charged to customers if they are to maintain returns attractive enough to retain private investment.

Building Buffers through Capital Conservation

We support the concept of carrying capital beyond the minimum requirements, as is common today on a case-by-case basis in the United States between banks and their supervisors.[32] We believe that such capital buffers derived from bank-specific, scenario-based stress tests would be far more meaningful than "hard-wired" buffers applied across the financial industry via the proposed capital conservation framework.[33] A scenario-based approach would allow regulators to take into account the specific characteristics of an individual bank, more effectively determine appropriate capital requirements, and better address the problem of pro-cyclicality. As stated in the letter published by the RMA, it is best if counter-cyclicality in general is fostered via the supervision process, in which supervisors promote capital buffers specific to individual institutions, depending on the details of that institution's risk profile and risk measurement and management capabilities."

Paras 256-259: The Proposed Capital Buffers Framework

[32] *See* Federal Reserve Supervisory Letter SR 99-18.
[33] RMA letter. *See also* "Scenario-Based, Bank-Specific Stress Tests", *infra*.

Like the Committee, we worry that publicly disclosed buffers would be viewed as new "de facto" minimum requirements.[34] Slipping into a buffer zone could elicit a more negative market reaction than a decline in capital ratios still in the "well-capitalized" range since it could imply that a bank is not meeting its regulators' expectations. We believe banks would start targeting capital levels above the buffer zones, holding even more capital than deemed optimal by the Committee. We therefore encourage the development of capital buffers through confidential dialogue between banks and their regulators.

Publicizing required buffers and a bank's position vis a vis those buffers would only lead to confusion about what constitutes a bank's minimum required capital and, in the U.S. regulatory framework, the meaning of the "well-capitalized" and "adequately capitalized" designations. Additionally, if a bank started depleting its buffer without the public having any meaningful context around why this was taking place, how long capital ratios would remain low, and what steps were being taken to improve the capital position, a run on the bank would not be unforeseeable and could introduce additional pro-cyclicality into the financial system.

Linking earnings distributions to capital levels could also result in dangerous signaling and potentially trigger downward bank spirals. Although there may be cases where limiting distributions upon capital depletion is appropriate, an individual approach between a bank and its supervisors would permit greater flexibility to account for different scenarios and avoid any unnecessary and unintended negative signaling effects.

Paras 260-262: Excessive credit growth

The Committee has proposed a "regime which would adjust the capital buffer range...when there are signs that credit has grown to excessive levels."[35] It seeks to identify a macro-economic group of variables that would indicate when credit has grown to excessive levels, thus triggering an increase in capital buffers.[36] Given the continuously evolving nature of the global economy and financial system, we have concerns that this is a difficult, if not impossible task, raising questions about how to determine where the economy is in the business cycle and how to avoid an uneven application internationally. Additionally, we worry about the potential moral hazard introduced by this specific proposal. We believe that, at certain points in the economic cycle, this could result in a "race to the bottom" whereby banks engage in riskier behavior in pursuit of higher returns with the knowledge that capital buffers would soon be adjusted on a global basis. We therefore encourage the Committee to reconsider this proposal.

Summary

The Committee rightly focuses on several key weaknesses in the international financial system, namely the need for additional and higher quality capital that can provide banks

[34] ABA letter, p.9 and CD, paragraph 257.
[35] CD, paragraph 261.
[36] CD, paragraph 262.

with an appropriate loss-absorbing cushion during times of acute stress. However, we believe that several of the CD's "one-size-fits-all" proposals may introduce unnecessary rigidity into the financial system and actually weaken the banking sector's capital base. Instead, we believe that reasonable quantitative requirements should be used in conjunction with scenario-based, bank-specific stress tests, which together would better measure an institution's health. This approach would also provide a level of flexibility against evolving economic conditions and ever-shifting accounting, tax, and other regulatory rules that inflexible ratios would not.

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Capital One appreciates the opportunity to comment on this Consultative Document. If you would like to discuss our comments, please contact me at (1)-703-720-1000.

Respectfully,

Gary L. Perlin
Chief Financial Officer