December 20, 2017

Via Electronic Mail

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219
Attention: Legislative and Regulatory Activities Division

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Attention: Ann E. Misback, Secretary

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Attention: Robert E. Feldman, Executive Secretary


Ladies and Gentlemen:

The Clearing House Association L.L.C.\(^1\) appreciates the opportunity to comment on the above-captioned notice of proposed rulemaking by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System and the Federal Deposit

\(^1\) The Clearing House is a banking association and payments company that is owned by the largest commercial banks and dates back to 1853. The Clearing House Association L.L.C. is a nonpartisan organization that engages in research, analysis, advocacy and litigation focused on financial regulation that supports a safe, sound and competitive banking system. Its affiliate, The Clearing House Payments Company L.L.C., owns and operates core payments system infrastructure in the United States and is currently working to modernize that infrastructure by launching a new, ubiquitous, real-time payment system. The Payments Company is the only private-sector ACH and wire operator in the United States, clearing and settling nearly $2 trillion in U.S. dollar payments each day, representing half of all commercial ACH and wire volume.
Insurance Corporation. For firms that do not meet the definition of an advanced approaches firm (“non-advanced approaches firms”), the proposal would introduce a simpler regulatory capital treatment for mortgage servicing assets (“MSAs”), certain deferred tax assets arising from temporary differences (“DTAs”), investments in the capital of unconsolidated financial institutions, and capital issued by a consolidated subsidiary of a firm and held by third parties (“minority interest”). The proposal also includes revisions to the treatment of acquisition, development, and construction (“ADC”) exposures under the standardized approach that would apply for all firms. The revisions relating to the treatment of ADC exposures are designed to address concerns regarding the current definition of high volatility commercial real estate (“HVCRE”) exposure.

The Clearing House supports the agencies’ efforts to simplify the regulatory capital rules and to address concerns with the definition of HVCRE exposure, and conceptually supports these aspects of the proposal. However, as set forth below, we believe that the agencies should revise certain aspects of the proposal and make other revisions to the capital rules. Part I of this letter describes our recommended revisions to the proposed definition of HVADC exposure. Part II explains why the agencies should apply all aspects of the proposal—including those relating to the treatment of MSAs, DTAs, investments in the capital of unconsolidated financial institutions and minority interest—to the standardized approach calculations for all firms. Part III addresses the capital treatment of accumulated other comprehensive income (“AOCI”) related to high-quality liquid assets (“HQLA”) of advanced approaches firms. Part IV presents our recommendations for the treatment of minority interest.

I. The agencies should revise the proposed definition of HVADC exposure and the manner of its implementation.

1. The definition of HVADC exposure should include an exemption based on borrower contributed capital.

As compared to the current definition of HVCRE exposure, the proposed definition of HVADC exposure would not include an exemption for exposures that are financed with substantial borrower contributed capital and that have loan-to-value (“LTV”) ratios less than or equal to the relevant supervisory LTV ratio standard. According to the proposal, firms have asserted that the conditions for meeting this exemption under the current definition of HVCRE exposure are “unclear, complex, and burdensome to implement.” However, rather than simplifying and clarifying this exemption and addressing implementation burdens, the proposed definition of HVADC exposure would eliminate this exemption in its entirety. For the reasons stated below, we urge the agencies to retain a contributed capital exemption.

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3 Id., at 49988.
The contributed capital exemption recognizes that exposures with lower LTV ratios and substantial borrower contributed capital have risk-reducing qualities that make the application of a risk weight above 100 percent inappropriate. Moreover, the exemption provides incentives for firms to originate ADC exposures with lower LTV ratios and substantial borrower contributed capital; eliminating the exemption could create perverse incentives for firms to originate ADC exposures with higher LTVs or less borrower contributed capital. Although the agencies note that they “considered various means to clarify or modify the contributed capital exemption”, the proposal does not discuss the various means that were considered by the agencies or request comment on them. We believe the agencies should do so, and we would welcome the opportunity to work with the agencies to clarify and simplify the contributed capital exemption and address implementation burdens. Below, we present our recommended revisions to this exemption. We believe that these revisions would allow the agencies to achieve their goals of simplifying the capital treatment of ADC exposures and reducing implementation burdens, while also appropriately recognizing the risk-reducing qualities of certain ADC exposures and providing prudent incentives for firms.

➢ The exemption included in the final definition of HVADC exposure should not require that either capital generated internally by the project or capital contributed in excess of the 15 percent minimum be contractually required to remain in the project throughout the life of the project, as is the case in the exemption in the current definition of HVCRE exposure. Rather, the exemption in the final definition of HVADC exposure should require only that the capital contributed by the borrower to meet the 15 percent capital contribution requirement be retained in the project. This approach would appropriately reflect that projects that become able to generate capital internally have different risk characteristics from those that have not reached, or do not reach, that stage. It would also remove incentives for borrowers to contribute as little capital as possible in order to avoid having contributed capital trapped throughout the life of the project. Accordingly, an exposure should not be treated as an HVADC exposure—and thus subject to higher capital requirements—on account of the borrower’s ability to withdraw internally generated capital or capital in excess of the 15 percent minimum.

➢ The value of land that is contributed to a project should be based on the current valuation of the land determined as of the date of contribution, as opposed to the original purchase price. Current supervisory guidance provides that cash used to purchase contributed land may count toward the contributed capital requirement, which inappropriately disregards appreciation, in particular with regard to land that has been held for a significant period of time by the borrower prior to contribution and that may have been acquired for a purchase price substantially below the current

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4 Id.
valuation. Basing the value of contributed land on the current valuation determined as of the date of contribution would more appropriately reflect the value of assets available to support the project that have been contributed by the borrower.

2. **The current definition of HVCRE exposure and the proposed definition of HVADC exposure should be collateral-based as well as purpose-based.**

To avoid inappropriately capturing certain types of exposures that are unsecured or secured by collateral other than real property, the proposed definition of HVADC exposure, and the current definition of HVCRE exposure (if it remains), should be revised to include both purpose-based and collateral-based requirements. According to the proposal, because the proposed definition of HVADC exposure—like the current definition of HVCRE exposure—is purpose-based but not collateral-based, ADC exposures that are not secured by real property could be considered HVADC exposures if the purpose of the facility is primarily to finance ADC activities. More specifically, under the proposed definition, to determine if a lending facility “primarily finances” ADC activities, a firm would be required to review the intended use of funds and if more than 50 percent will be used for ADC activities, the facility would fall within the scope of the HVADC exposure definition, whether or not the facility is secured by real property, unless an exemption applies.

Basing a determination of whether an ADC exposure is an HVADC exposure solely on the purpose-based “primarily finances” test could inappropriately capture unsecured loans or loans secured by collateral other than real property that should not be treated as HVADC exposures, such as unsecured loans to real estate investment trusts (“REITs”) or margin loans to wealth management customers. Unsecured loans and loans secured by collateral other than real property have risk and other characteristics that differ fundamentally from ADC exposures secured by real property. Unsecured loans and loans secured by collateral other than real property are likewise subject to underwriting standards and risk management processes that significantly differ from those applicable to ADC exposures secured by real property.

In addition, a collateral-based test would be consistent with the exclusion of “permanent loans” from the proposed definition of HVADC exposure, which excludes “prudently underwritten loan[s] that ha[ve] a clearly identified ongoing source of repayment sufficient to service amortizing principle and interest payments aside from the sale of the property.” This exclusion appropriately recognizes that, for certain loans financing ADC projects, repayment is not subject to ADC-related risk. Excluding unsecured loans and loans secured by collateral

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6 Proposal, at 49988.
7 Id., at 49989.
8 See id. (“[T]he agencies recognize that for loans financing owner-occupied acquisition, development, or construction projects, the owner may have sufficient capacity at origination to repay the loan from ongoing operations, without relying on proceeds from the sale or lease of the property, in which case the loan would
other than real property would similarly recognize that repayment of those loans is not subject to ADC-related risk.

Moreover, whether or not firms ultimately determine that any unsecured loans and loans secured by collateral other than real property are captured by the proposed definition of HVADC exposure and thus subject to a higher risk weight, the firms would be required to devote resources to evaluate those loans against the definition, which represents an undue operational and compliance burden. Consistent with the objectives of the proposal, a collateral-based requirement would make the capital treatment of ADC exposures more risk-sensitive, as well as simpler and less burdensome. The rationales for a collateral-based requirement apply with equal force to the current definition of HVCRE exposure as well. Accordingly, the agencies should add a collateral-based test to the current definition of HVCRE exposure and the proposed definition of HVADC exposure to require that HVCRE and HVADC exposures also be secured by real property.

3. Firms should be permitted to opt out of the grandfathering provision by adopting early the new definition of HVADC for all ADC exposures and therefore be permitted to evaluate all ADC exposures against the definition of HVADC exposure irrespective of the date of origination.

To “mitigate the potential burden on banking organizations of having to re-evaluate all of their [ADC] exposures against the new HVADC exposure definition,”9 the proposal would grandfather, under the standardized approach, ADC exposures originated before the effective date of the proposal’s revisions and would apply the definition of HVADC exposure and the 130 percent risk weight only to exposures originated on or after that date. Accordingly, firms would not be required to re-evaluate pre-existing exposures under the new framework for HVADC exposures; rather, they would continue to apply the current framework for HVCRE exposures to those exposures. We support the proposal’s inclusion of a grandfathering provision in recognition of the potential burdens on firms. However, we also believe that firms should have the option to opt out of this grandfathering and apply the new definition of ADC exposures without regard to their date of origination. Grandfathering existing exposures may mitigate operational and compliance burdens for some firms by avoiding the need to re-evaluate pre-existing exposures under a new definition, but for other firms grandfathering may exacerbate operational and compliance burdens by requiring that they monitor ADC exposures against different definitions depending on when the exposures were originated. To allow firms

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9 Id., at 49990.
flexibility in determining which approach is most appropriate in their particular circumstances and to further mitigate potential implementation burdens, firms should be permitted to opt out of the grandfathering provision and apply the definition of HVADC to all ADC exposures without regard to their date of origination in order to avoid two disparate frameworks for ADC exposures based solely on the origination date for the exposure.

The implementation of a new framework for evaluating and risk weighting ADC exposures will reflect the agencies’ determination that the new framework is more appropriate than the current framework centered on the definition of HVCRE exposure and a 150 percent risk weight. Accordingly, firms should be permitted to apply the new HVADC framework to their exposures originated before the effective date of the definition of HVADC exposure irrespective of the effect on their risk-weighted assets.

4. The proposed 130 percent risk weight for HVADC exposures is too high and should be recalibrated.

Under the current HVCRE framework, the standardized approach applies a 150 percent risk weight to all HVCRE exposures, indicating that the risk is commensurate to that of past due exposures. Although the proposal notes that the agencies believe that the broader HVADC definition and lower risk weight of 130 percent “would not result in a significant change in the aggregate minimum capital required under the capital rule”, the agencies do not offer an empirical analysis for their belief, nor do they provide an empirical analysis of whether the current capital requirements for HVCRE exposures are appropriate. Rather, the agencies note the difficulty of estimating the impact of the proposal. We urge the agencies to provide, for comment and in advance of finalizing the proposal, an empirical analysis of the current treatment of HVCRE exposures and the proposed new HVADC framework, including the calibration of the proposed 130 percent risk weight for HVADC exposures.

The proposal appears to be premised on two assumptions: that the current calibration for HVCRE exposures is appropriate and that, if the proposal keeps broadly similar capital requirements, the calibration for HVADC exposures is also appropriate. We do not agree with either assumption.

The current calibration for HVCRE exposures is not appropriate because the risk characteristics of HVCRE exposures do not justify a 150 percent risk weight. The treatment of HVCRE versus non-HVCRE exposures under the advanced approaches makes the standardized approach’s punitive treatment of HVCRE exposures clear. Under the advanced approaches, the

10 *Id.*

11 *See id.* (“Because of the lack of granular data on acquisition, development, or construction loans in the regulatory reports and since agencies cannot predict how banking organizations may structure such exposures in the future, the agencies cannot estimate with precision the future impact of the proposed HVADC exposure definition at an individual banking organization level.”).
different capital requirements for HVCRE and non-HVCRE wholesale exposures are implemented through the formulas for calculating the correlation factor.\footnote{See Table 1 to 12 CFR §§ 3.131 (OCC), 217.131 (Federal Reserve) and 324.131 (FDIC).} For a given set of risk parameters, these formulas result in substantially lower disparities in the risk-weighted assets for HVCRE and non-HVCRE exposures than the disparities under the standardized approach for HVCRE and non-HVCRE exposures, as the standardized approach applies a 50 percent differential to all HVCRE exposures (150 percent versus 100 percent risk weights). Moreover, HVCRE risk-weighted assets under advanced approaches calculations frequently reflect a risk weighting that is significantly lower than 150 percent (and, in some cases, lower than 100 percent), providing further evidence that the 150 percent risk weight in the standardized approach is too high.

In addition, neither the current framework for HVCRE exposures nor the proposed framework for HVADC exposures is risk-sensitive, as each applies a single elevated risk weight to a wide population of exposures without making any distinctions among those exposures in light of risk-related or other relevant characteristics. Indeed, the proposal would exacerbate the current flaws by subjecting a broader population of ADC exposures to an elevated risk weight. We therefore recommend that the agencies introduce a more risk-sensitive framework for ADC and other exposures secured by real property that appropriately balances simplicity and risk sensitivity. One possible approach would be to segment risk weights for those exposures by LTV ratios, and we would welcome the opportunity to work with the agencies to develop such an approach.

5. \textbf{The same definitions should be used for purposes of standardized approach and advanced approaches calculations if the final HVADC exposure definition includes a borrower contributed capital exemption.}

The proposal would not revise the treatment of HVCRE exposures for purposes of the advanced approaches, which would require advanced approaches firms to use different definitions for their standardized approach and advanced approaches calculations. The proposal would thus result in operational and compliance burdens for advanced approaches firms, which would be required to maintain separate and duplicative operational procedures to identify HVADC exposures for purposes of standardized approach calculations and HVCRE exposures for advanced approaches calculations. The proposal would also introduce additional complexity into the capital rules by using similar—but different—definitions to identify those ADC exposures that should be subject to more stringent capital requirements in the standardized and advanced approaches.

In addition, a firm that becomes subject to the advanced approaches after the effective date of the proposal would be required to apply the HVCRE definition to all its ADC exposures for purposes of its advanced approaches calculations, whether such exposures were originated...
before or after the effective date. As a result of the potential need to re-evaluate post-effective date exposures under the HVCRE definition in the advanced approaches, firms that may become subject to the advanced approaches in the future might continue to apply and monitor post-effective date ADC exposures against the HVCRE definition in order to facilitate their possible future implementation of the advanced approaches. This could frustrate the objective of the agencies to allow non-advanced approaches firms to cease to apply the “unclear, complex, and burdensome”13 HVCRE definition and instead apply the simpler HVADC definition to ADC exposures originated after the effective date.

The proposal asks whether it would be appropriate to replace the HVCRE exposure definition in the advanced approaches with the HVADC exposure definition.14 We believe that it is, so long as the final HVADC exposure definition includes a borrower contributed capital exemption. In that case, we urge the agencies to do so.

If, however, the final definition of HVADC exposure eliminates the exemption based on borrower contributed capital—which we oppose—and the agencies implement that definition for purposes of the advanced approaches, the agencies should also recalibrate the advanced approaches formula used to calculate risk-weighted assets for HVCRE exposures in order to reflect the broader scope of such a definition.15

II. The agencies should apply all aspects of the proposal to the standardized approach calculations of all firms.

We recognize that there could be capital and other rules where the benefits of simplicity might, in some circumstances, outweigh the benefits of more granular approaches, even at the sacrifice of some accuracy. In this case, however, we do not believe that simplicity is at the expense of accuracy. Accordingly, we believe that any of the proposed simplifications that are adopted for non-advanced approaches firms should be applied to advanced approaches firms as well.

Moreover, although we support the agencies’ initiative in seeking to balance simplicity with risk-sensitivity in the changes presented in the proposal, we do not believe the proposal strikes an appropriate balance. As The Clearing House has previously explained,16 the

13 Proposal, at 49988.
14 Id., at 49991.
15 See Table 1 to 12 CFR §§ 3.131 (OCC), 217.131 (Federal Reserve) and 324.131 (FDIC).
dichotomy between non-advanced and advanced approaches firms makes the capital rules size-sensitive rather than risk-sensitive, as size is treated as an absolute proxy for risk. The proposal would only compound this flaw in the capital rules.

The proposal would also introduce additional complexity into the capital rules by effectively creating two versions of the standardized approach—one that applies to non-advanced approaches firms and another that applies to advanced approaches firms—without creating a commensurate benefit, such as a properly calibrated, risk-sensitive framework. Of course, we fully support the appropriate tailoring of prudential requirements to the relative risk profile, business model and other risk-related criteria of different firms.17 The continued use of the dichotomy between non-advanced and advanced approaches firms does not, however, further that critical objective.

Rather than exacerbating dichotomies, imposing more stringent requirements based on size alone and introducing undue complexity into the capital rules (as the proposal would do), the agencies should extend all of the proposed simplifications—including those relating to the treatment of MSAs, DTAs, investments in the capital of unconsolidated financial institutions and minority interest—to advanced approaches firms for purposes of their standardized approach capital calculations, thereby promoting simplicity and consistency for firms of all sizes, as well as overall simplicity of the capital rules.

III. The agencies should allow advanced approaches firms to opt out of recognizing unrealized gains and losses on HQLA in regulatory capital.

The Clearing House has long believed that the requirement that advanced approaches firms recognize most18 AOCI elements in regulatory capital—including unrealized gains and losses on available-for-sale (“AFS”) securities—is substantively inappropriate and could have deleterious effects on individual firms, financial markets, credit availability and economic growth and, potentially, financial stability.19 Since the U.S. Basel III-based capital rules were finalized, and the revised treatment of most AOCI elements for advanced approaches firms

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18 An advanced approaches firm is not required to recognize accumulated net gains and accumulated net losses on cash flow hedges included in AOCI that relate to the hedging of items that are not recognized at fair value on the firm’s balance sheet. See 12 CFR §§ 3.22(b)(1)(iii) (OCC), 217.22(b)(1)(iii) (Federal Reserve) and 324.22(b)(1)(iii) (FDIC).

became effective, it has become necessary for advanced approaches firms to hold larger portfolios of investment securities, which are frequently classified as AFS, due to new liquidity requirements (i.e., the liquidity coverage ratio (“LCR”)) and more stringent supervisory expectations regarding resolution planning (in particular those relating to pre-funded intermediate holding companies and contractually binding mechanisms to govern the provision of capital and liquidity support to a firm’s operating subsidiaries in a resolution scenario\(^{20}\)). In light of these developments, a re-evaluation of the capital treatment of AOCI for advanced approaches firms is warranted.

The requirement that advanced approaches firms recognize most elements of AOCI in regulatory capital is inconsistent with regulatory regimes requiring these firms to increase the size of their investment securities portfolios. The current treatment of AOCI creates incentives for advanced approaches firms to classify fewer investment securities as AFS and to shorten the duration of their AFS securities portfolio in order to mitigate the impact of fluctuations in AOCI on regulatory capital. These incentives discourage firms from engaging in investing activities that are routinely used as important asset-liability management tools. The current treatment of AOCI related to HQLA classified as AFS also increases the burdens on firms in meeting LCR requirements and heightened supervisory expectations regarding resolution planning. In light of the inconsistency between the capital rules and other regulatory regimes, we urge the agencies to allow advanced approaches firms to opt out of recognizing unrealized gains and losses on HQLA classified as AFS in regulatory capital.

We recognize that changes to the measurement of regulatory capital for purposes of advanced approaches capital ratios are beyond the scope of the proposal. We believe it is nevertheless important to note that the changes we recommend in this Section III and Section II for advanced approaches firms’ standardized approach calculations should also extend to their advanced approaches calculations, assuming and for so long as the advanced approaches are retained. As for the standardized approach calculations, reflecting these changes in advanced approaches calculations would promote the simplicity of the capital rules and, in the case of the treatment of AOCI, result in a more appropriate measurement of regulatory capital that does not have an adverse impact on firms’ asset-liability management activities or create inconsistencies with other regulatory regimes that require firms to hold significant amounts of investment securities. Accordingly, once the proposal is finalized, we urge the agencies to raise our recommendations in this Section III and Section II with the Basel Committee so that these recommendations may be considered for inclusion in the advanced approaches calculations under the Basel Committee’s capital adequacy framework.

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IV. The agencies should reconsider the proposed limitations on the inclusion of minority interest in capital.

The proposal would allow non-advanced approaches firms to include CET1 minority interest, tier 1 minority interest, and total capital minority interest up to 10 percent of the parent’s CET1, tier 1, and total capital elements, respectively (before the inclusion of any minority interest and after certain deductions and adjustments). Although the proposed limitations are simpler to apply than the current limitations, we believe the proposal could have unintended adverse consequences, in particular in a stressed environment. In such an environment, per the proposed limitations, the amount of includable minority interest would decline as a firm’s capital decreases, which would amplify the effects of a decrease in capital. Reducing the amount of includable minority interest as a result of declines in a firm’s capital is starkly different from the current limitations, under which the amount of includable minority interest is not affected by changes in the firm’s capital but is, rather, determined by reference to the subsidiary’s capital and risk-weighted assets.

In addition to the potential adverse consequences in a stressed environment, the proposed limitations on minority interest could also affect firms’ funding costs. The proposed limitations would provide firms with incentives to issue tier 2 capital instruments at the holding company level rather than at a subsidiary bank, which would frequently result in increased funding costs. In light of these potential negative effects and those discussed above, should the agencies determine to change the limitations on minority interest, we believe that calculating includable minority interest as a percentage of risk-weighted assets would be more appropriate than calculating includable minority interest as a percentage of capital. This is because capacity based on risk-weighted assets is likely to be less volatile than capacity based on capital, in particular in a stressed environment.

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The Clearing House appreciates your consideration of the views expressed in this letter. If you have any questions, please contact the undersigned by phone at (212) 613-9883 or by email at david.wagner@theclearinghouse.org.

Respectfully submitted,

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The Clearing House Association L.L.C.
cc: Michael Gibson  
    Mark Van Der Weide 
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