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Karen Shaw Petrou
Executive Director

April 4, 2006

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, DC 20219
Docket Number 05-22

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket Number R-1243

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
FDIC: EGRPRA burden reduction comments

Regulation Comments
Office of Thrift Supervision
Chief Counsel's Office
1700 G Street, NW.
Washington, DC 20552
Attention No: 2005-53

Dear Sir and Madam:

The Financial Guardian Group (FGG) is pleased to comment on the agencies' request for regulatory-burden reduction suggestions related to the current "prompt corrective action" (PCA) requirements published in the January 4, 2006 *Federal Register*. We very much appreciate the focus on reducing regulatory burden and believe that changes to PCA in light of the anticipated revisions to current risk-based capital rules are appropriate not only for substantive reasons, but also as part of this overall relief initiative.

Below, we reiterate points made in prior comments regarding the undue burden and adverse impact of retaining PCA at current levels under Basel IA and Basel II. You have asked for information about the degree to which the PCA requirement is mandated under current law, and comment is provided on this as well. Should the agencies decide to retain PCA at current levels, at least for an initial period of time under Basel IA and II, then we recommend, as discussed below, that the leverage and risk-based capital PCA standards be imposed only at the insured depository, not also at the holding company.

I. Legislative Flexibility

You have asked for comment on the degree to which the agencies may move under current law to adopt commenter suggestions for regulatory-burden relief. Importantly, U.S. bank regulators have considerable flexibility over the leverage and risk-based capital (RBC) PCA standards under current law. The leverage standard, which is found at Section 131(c) of FDICIA (12 USC 1831o(c)), grants the Federal banking agencies total discretion in setting the leverage standard other than the ratio for a "critically undercapitalized" insured depository institution. This is set by law as at least 2 percent of total assets and not more than 65 percent of the required minimum.

We understand that regulators wish to keep the PCA framework meaningful by ensuring appropriate differences between the regulatory capital ratios that differentiate critically under-capitalized institutions from those holding other capital ratios, including those that deem an institution "adequately" or "well" capitalized. However, the current ratios for these determinations – a 5% Tier 1 leverage ratio and 10% Tier 1 plus Tier 2 RBC ratio – are far in excess of those required once other risks are reflected in RBC.

Money market assets and very short maturity U.S. Treasury and Government Agency securities have very little credit or interest rate risk inherent in them. An institution with abundant liquidity that resulted from taking client deposits onto their balance sheet could invest them in these types of very low risk assets and should only attract a very small amount of incremental capital from a pure Basel IA and Basel II risk based perspective. Keeping the current PCA criteria is unnecessary, especially for specialized banks with very low credit and interest-rate risk profiles.

II. Adverse Impact

Further, the PCA standards would create perverse incentives against all of the risk management and mitigation goals at which the entire risk-based capital rewrite exercise is aimed. Proponents of the standards argue that they are necessary to protect against unwise drops – some fear even precipitous ones – suggested by the agencies' fourth quantitative impact survey (QIS-4). However, as the agencies have now confirmed in their QIS-4 paper[1], the QIS4 results are not a good indicator of actual Basel II capital once credit RBC is appropriately stress-tested and other criteria not addressed in the study are calculated.

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[1] *Summary Findings of the Fourth Quantitative Impact Study*, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of the Thrift Supervision, March 2, 2006.

However, to the degree that the agencies decide to retain the PCA thresholds, this should be done only for insured depositories, not for parent holding companies. While regulatory capital can be consolidated at the holding-company level, as required under Basel II, unique U.S. banking-agency provisions such as the leverage requirement should not apply outside the insured depository affiliate.

III. Holding-Company Exemption

In fact, Congress has made clear that it does not want bank or savings-association style capital applied to parent holding companies. The PCA standards expressly apply only to insured depositories, not to parent holding companies.[2] In 1999, Congress also expressly mandated that financial holding company activities may be limited based only on subsidiary insured-depository capital adequacy, not that of the parent holding company.[3] Indeed, it is most unclear if the Office of Thrift Supervision even has authority over capital adequacy at parent holding companies of savings associations. Although the agency may be a "conglomerate" regulator,[4] its ability to assess its parent companies is based on agreements by such firms that OTS may do so. Without such authority, Congress has given the agency only limited authority over savings association parent firms.[5]

Some may counter that it is necessary to apply these standards at the holding-company level to prevent regulatory arbitrage. This is, however, inappropriate for both competitive and supervisory reasons. First on the competitiveness point, as noted, it is unclear if OTS could impose these standards at the holding-company level, especially when unitary thrift holding companies are controlled by non-banking organizations. Thus, application of such standards would differentiate between bank and savings-association parents in an unnecessary and inappropriate fashion that might encourage charter choice. Considerable adverse competitive distinctions could result between savings associations owned by financial holding companies and unitary ones outside OTS parent-company regulation, with potentially significant mortgage and credit-card market impact.

Secondly, the Securities and Exchange Commission has not imposed a leverage requirement or standards comparable to the PCA ones in its rules applying Basel II standards to "consolidated supervised entities,"[6] nor has the Commodity Futures Trading Commission included this in comparable rules for futures commission merchants.[7] A decision by the agencies to mandate bank and/or financial holding company consolidated capital with leverage and PCA standards would thus also pose a competitive problem for institutions with significant investment banking and similar activities.

From a supervisory point of view, it is also unnecessary to impose the PCA standards. The Federal Reserve has ample authority to ensure that holding-company activities do not pose undue risk to insured-depository affiliates without recourse to the leverage and PCA standards. For example, the

[2] 12 U.S.C. § 1831o.
[3] P.L. 106-102.
[4] *Regulatory Bulletin RB 35: Large and Complex Enterprises (Conglomerates)*, Office of Thrift Supervision, November 20, 2003.
[5] 12 U.S.C. § 1467a.
[6] 12 CFR Parts 200 and 240.
[7] *Alternative Market Risk and Credit Risk Capital Charges for Futures Commission Merchants and Specified Foreign Currency Forward and Inventory Capital Charges*, Final Rule, Commodity Futures Trading Commission, February 2, 2006.

Board has extensive authority under the recently-revised Sections 23A and 23B of the Federal Reserve Act to ensure that inter-affiliate transactions do not threaten insured depositories.[8] The Board also has broad authority to ensure that holding companies are able to act as a "source of strength" to subsidiary insured depositories.[9] Finally, the Board has recently adopted a new supervisory framework for bank holding companies designed to ensure that non-banking affiliates are operated in a safe and sound fashion.[10] All of this, the FGG believes, is more than sufficient to ensure that holding companies will be managed in a prudential fashion without the need to apply leverage and PCA standards to them.

IV. Conclusion

The banking agencies have considerable flexibility under current law to make the PCA standards compatible with the incentives at which the Basel IA and Basel II RBC rewrites rightly aim. The agencies have correctly noted the regulatory burden that would accompany retention of the PCA standards in this request for comment and we urge that the burden issues be fully incorporated into the decision-making on the Basel rules going forward.

We would be pleased to provide any additional information that would be of assistance.

Sincerely,

Karen Shaw Petrou
Executive Director

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[8] 12 USC § 371c-1 and 12 C.F.R. Part 223.
[9] 12 C.F.R. 225.4(a)(1) and *Board of Governors* v. *First Lincolnwood Corp.*, 439 U.S. 234 (1978).
[10] *Bank Holding Company Rating System*, Supervisory Letter SR 04-18, Board of Governors of the Federal Reserve System, December 6, 2004.