Morgan Stanley

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Re: Capital Proposals for Large U.S. Banking Organizations

Ladies and Gentlemen:

We appreciate the opportunity to comment on the notice of proposed rulemaking published by the Board of Governors of the Federal Reserve System (the "**Board**"), the Office of the Comptroller of the Currency ("**OCC**") and the Federal Deposit Insurance Corporation ("**FDIC**") (collectively, the "**Agencies**") to implement the revised Basel III Accord (the "**B3EG Proposal**")[1] and, separately, the notice of proposed rulemaking published by the Board to revise the G-SIB Surcharge framework (the "**G-SIB Surcharge Proposal**").[2]

Our preliminary assessment of the B3EG Proposal is that it would, as of mid-2023 and in the absence of mitigating actions, result in a roughly 40 percent increase in our risk-weighted assets ("**RWAs**")[3]—primarily as a result of new Operational Risk RWAs—and introduce significant frictions with the Board's stress capital buffer ("**SCB**") framework, which the Board designed and calibrated to apply to the legacy standardized approach RWA framework (the "**Standardized Approach**"). Our concerns with the B3EG Proposal include the absence of a clearly identified problem to be solved by the rulemaking; the strength and rigor of post-financial crisis regulatory standards applied to U.S. Global Systemically Important Banks ("**U.S. G-SIBs**"), which suggest the rulemaking is unnecessary; negative anticipated impacts on end users' affordable access to credit and hedging; the failure to harmonize supervisory stress testing; increased divergence between regulatory standards in the United States and other major jurisdictions, particularly the UK and European Union; over-calibration of operational risk

[1] 88 Fed. Reg. 64,028 (Sep. 18, 2023). Docket No. R–1813, RIN 7100–AG64 (Board), Docket ID OCC–2023–0008 (OCC), RIN 3064–AF29 (FDIC).
[2] 88 Fed. Reg. 60,385 (Sep. 1, 2023). Docket No. R–1814, RIN 7100–AG65 (Board).
[3] Morgan Stanley Form 10-Q for the quarter ended September 30, 2023, p. 29 (here).

capital requirements, including new and unnecessary frictions for fee- and commission-based business models; and a diverse range of technical issues that would introduce significant risk, operational and capital management challenges for capital markets businesses and have significant first- and second-order impacts on the financial system and important components of the U.S. economy.

Given the significant concerns raised by the B3EG Proposal, we believe the B3EG Proposal should not be adopted as a final rulemaking. Instead, we recommend:

- First, the Agencies should conduct and publish for comment a quantitative analysis of regulatory capital standards, inclusive of the interplay of supervisory stress testing with RWA-based requirements, applicable to large U.S. banking organizations as well as a related economic impact analysis of how implementation of the revised Basel III Accord would impact the U.S. economy. These analyses, inclusive of public comments in response, should be used to determine whether it is necessary and beneficial to implement the revised Basel III Accord in any form in the United States. These analyses might reasonably conclude that the existing U.S. regulatory capital framework—already strengthened by more than a decade of post-financial crisis reforms—is sufficiently robust without further changes and appropriately supports U.S. economic growth and stability.

- Second, if the Agencies' regulatory capital quantitative analysis and related economic impact analysis each support a conclusion that implementation in some form of the revised Basel III Accord is necessary and beneficial, the Agencies should prepare a revised proposed rulemaking that supports economic growth and job creation in the capital markets-oriented U.S. economy, is integrated with the larger U.S. regulatory framework consistent with safety and soundness, and more clearly advances the objective of establishing more consistent baseline minimum capital standards across major jurisdictions. We respectfully submit that our comments in this letter, including the related technical Appendices, should inform any future rulemakings or other steps taken to implement the revised Basel III Accord in final standards.

Key Concerns

It is unclear what problem the B3EG Proposal is designed to solve

We support robust, conservative regulatory capital and related prudential requirements. Large U.S. banking organizations are stronger today and better able to meet the needs of clients and markets through the economic cycle with the benefit of post-financial crisis capital, liquidity, stress testing and recovery and resolution planning standards. Unlike prudential standards introduced in the decade after the financial crisis, however, the B3EG Proposal does not appear designed to solve a specific, identified problem in the regulation of U.S. G-SIBs. While the B3EG Proposal cites regional bank failures from spring 2023 as justification for the proposed standards, that episode highlighted the strength of U.S. G-SIBs rather than shortcomings that would justify regulatory changes.[4] The B3EG Proposal does not

[4] Agencies, "Press Release: Agencies request comment on proposed rules to strengthen capital requirements for large banks," Jul. 27, 2023 (here).

explain why U.S. GSIBs' capital standards—already calibrated conservatively in response to financial crisis evidence—warrant significant further increases even when the Basel Committee "did not intend [for] the proposal to require banks to hold more capital."[5]

Post-financial crisis reforms have been effective for the U.S. G-SIBs

As the Board recently observed, a large majority of banking organizations are well capitalized, especially U.S. G-SIBs.[6] The Board's analysis shows that U.S. G-SIBs' risk-based capital ratios were, as of the end of 2022, approximately two-and-a-half times higher than they were during the financial crisis.[7] The B3EG Proposal cites the financial crisis repeatedly as a justification for the proposed standards but does not analyze the adequacy or shortcomings of the numerous other regulatory standards—the original Basel III capital final rulemaking, stress testing, capital buffers, liquidity and funding regulation, recovery and resolution planning, single counterparty credit limits, derivatives margin requirements—adopted by the Agencies in the wake of the financial crisis.[8] This absence is particularly striking in the case of the Board's regulatory capital framework, which has relied on Comprehensive Capital Analysis and Review ("**CCAR**") supervisory stress testing for more than a decade. If regulatory capital levels as assessed under CCAR have been robust in recent years at the largest U.S. banking organizations—which the Board has repeatedly asserted publicly[9]—then significant further RWA increases are unnecessary.

The B3EG Proposal would negatively impact end users and capital markets

The United States has the most dynamic capital markets in the world, meeting 75 percent of U.S. non-financial corporates' debt financing needs and providing individual citizens with a wide range of products to meet their savings, investment and retirement planning objectives.[10] The B3EG Proposal has the general effect of penalizing capital markets activities, which are vital to U.S. economic functioning and growth and provide the United States with significant economic advantages.[11] By contrast, in Europe, only 11.5 percent of non-financial corporates' debt financing needs are met through the capital markets,

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[5] Congressional Research Service, "Bank Capital Requirements: Basel III Endgame," Nov. 30, 2023, p. 16 n. 54 (here).

[6] Board, "Financial Stability Report," May 2023, p. 37 (here).

[7] Board, "Financial Stability Report," May 2023, p. 37, Figure 3.3. (here).

[8] In 2013, Board staff recommended adoption of the Standardized Approach RWA framework in connection with the original Basel III final rulemaking on the basis that the Standardized Approach "would harmonize the banking agencies' calculation of risk-weighted assets and address shortcomings in risk-based capital requirements identified by the agencies, including during the recent financial crisis." Board staff, "Draft Final Regulatory Capital Rule and Market Risk Notice of Proposed Rulemaking -- Revised Memo to the Board," (Jul. 1, 2013), p. 10 (here).

[9] For the past decade, the Board has publicly asserted each June that the results of its annual supervisory stress testing exercise demonstrate the strong capital positions of the largest U.S. banking organizations. See, e.g., Board, "Press Release: Federal Reserve Board releases results of annual bank stress test, which demonstrates that large banks are well positioned to weather a severe recession and continue to lend to households and businesses even during a severe recession," Jun. 28, 2023 (here).

[10] SIFMA 2023 Capital Markets Fact Book ("**Capital Markets Fact Book**"), Jul. 2023, p. 6 (here).

[11] See, e.g., Gary Gensler, "'Exorbitant Privilege: Responsibilities and Challenges': Prepared Remarks before the Council on Foreign Relations," Dec. 4, 2023 (here) ("**Gensler Dec. 2023 Speech**") ("The U.S. capital markets are the deepest, most liquid in the world. At 40 percent of the world's capital markets, they outpace our 24 percent share of the world economy. . . The size, depth, liquidity, and features of U.S. capital markets bring privileges to anyone raising funds in our markets by lowering the cost of funding. This benefits how we as a nation borrow in our Treasury markets. It also affects private sector issuers both domestic and international.").

mitigating the effect of significant Market Risk RWA increases.[12] The impact to end users reliant on U.S. capital markets is largely unexamined by the B3EG Proposal, notwithstanding the Agencies' estimates of a 77 percent projected increase in U.S. GSIBs' Market Risk RWAs.[13]

Impacts to end users will be further amplified through the introduction of new Operational Risk RWAs—which, based on the Agencies' estimates, drive 78 percent of the proposed RWA increase relative to the Standardized Approach[14]—which apply across all trading, lending and services activities but will have particularly pronounced effects on end users that rely on banking organizations' services-oriented activities. The impacts of these proposals are thus much broader and deeper than just on banking organizations, which as intermediaries will pass higher costs onto consumers, borrowers, corporations as well as firms that use capital markets for investing, hedging and risk management. Finally, U.S. end users will likely be more impacted than those in Europe given the outsized impact of the B3EG Proposal on U.S. banking organizations, the distinct capital markets orientation of the U.S. economy, and the broad-based reliance by end users on U.S. banking organizations' services-oriented business lines.

The revised RWA framework would result in over-calibration of capital requirements when combined with the SCB

The Board adopted the SCB, in 2020, to apply to Standardized Approach RWAs.[15] The SCB incorporates firm-specific operational loss and Credit Valuation Adjustment ("**CVA**")-type estimates in supervisory stress tests to supplement Standardized Approach-defined capital requirements, which do not directly include these risks in RWA components. Applying, for the first time, the SCB to RWAs that include Operational Risk and CVA necessarily raises questions about the calibration of the overall capital framework. The Board has repeatedly affirmed that that the existing capital framework—in which the SCB incorporates CCAR-estimated losses to define capital ratio standards for Standardized Approach RWAs—is well calibrated before the addition of Operational Risk and CVA RWAs. Similar but distinct concerns arise from the interplay of the Global Market Shock ("**GMS**") component of supervisory stress tests with revised Market Risk RWAs, each of which is calibrated to stress period market evidence, including longer liquidity horizons, greater capture of tail risks, and reduced recognition of diversification. In effect, in many areas, the B3EG Proposal raises "baseline" capital requirements to stress period calibrations, requiring CCAR to be recalibrated in turn to harmonize the two frameworks.

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[12] Capital Markets Fact Book, Jul. 2023, p. 6 (here). See also Gary Gensler, Gensler Dec. 2023 Speech ("In the U.S., debt capital markets facilitate 75 percent of debt financing of non-financial corporations. In Europe, the U.K., and Asia, only 12-29 percent is raised in capital markets.") (here).

[13] 88 Fed. Reg. at 64,168 (Table 11). Market Risk RWAs for Category I and II holding companies would increase, under the B3EG Proposal's estimates, from $430 billion to $760 billion, or 77 percent.

[14] 88 Fed. Reg. at 64,168 (Table 11). The addition of an estimated $1.4 trillion of Operational Risk RWAs in Expanded RWAs is 78 percent of the overall $1.8 trillion RWA increase over the Standardized Approach for Category I and II holding companies.

[15] See, e.g., 85 Fed. Reg. 15,576, 15,587 (Mar. 18, 2020) (explaining that a firm's "stress capital buffer requirement as calculated using the standardized approach" will become a new buffer requirement); 85 Fed. Reg. at 15,590 (acknowledging that "the [SCB] final rule significantly changes how stress tests factor into capital requirements" and summarizing the Board's impact analysis, which was necessarily limited to impacts under the Standardized Approach framework).

The B3EG Proposal increases global regulatory divergence

Implementation of Basel Accord standards should, in principle, result in generally consistent rules applying to large banking organizations operating in different jurisdictions. The B3EG Proposal does not advance this principle. The B3EG Proposal is over-calibrated relative to global Basel Accord standards, in particular through the introduction of a new, 100 percent-calibrated RWA framework largely reliant on standardized methodologies ("**Expanded RWAs**") (as compared with the 72.5 percent-calibrated standardized approach backstop in the global Basel Accord); elimination of model-based Credit Risk calculations; and application of U.S.-only SCB and G-SIB Surcharge Method 2 requirements to Expanded RWAs.[16] These are unique and significant features of the B3EG Proposal, which are not found in either the revised Basel Accord or other major jurisdictions' implementations of the Accord. The contrast between U.S. and European/UK approaches to implementation of the revised Basel Accord is particularly striking, with more severe calibrations applying to U.S. banking organizations despite the relative strength and stability of U.S. G-SIBs since the financial crisis.[17]

Proposed Operational Risk RWA standards are mis-calibrated and would introduce unwarranted penalties on fee- and commission-based business models

The B3EG Proposal includes a proposed Operational Risk RWA methodology that calibrates capital requirements to fifteen years of operational risk losses. In addition to the general over-calibration of proposed Operational Risk capital standards, the specific methodology applied to fee- and commission-based business models would introduce significant headwinds for a range of activities—including asset management, wealth management and custodial services—that U.S. G-SIBs invested in to diversify revenue streams and reduce risk profiles following the financial crisis. Morgan Stanley exemplifies this strategic pivot, growing our fee- and commission-oriented Wealth and Investment Management segments from approximately one-quarter to more than half of our overall profit mix, providing recurring and durable income streams to our franchise.[18] The B3EG Proposal undermines strategic diversification into fee- and commission-based businesses without any analysis of the anticipated impact of the proposed Operational Risk methodology on banking organizations' business models, including whether this methodology reflects a deliberate policy choice to discourage fee- and commission-based businesses. More generally, the B3EG Proposal does not justify or explain specific calibration choices in the proposed Operational Risk methodology, such as the fifteen-year operational loss mechanic, which the Basel Committee adopted without any public consultation or explanation. In substance, proposed Operational Risk RWA standards raise baseline capital requirements for all activities without any empirical analysis of the loss histories or risk profiles of these activities.

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[16] The B3EG Proposal permits (similar to Europe) large U.S. banking organizations to utilize model-based calculations for Market Risk RWAs. However, Credit Risk RWAs are a much larger driver of overall capital requirements, as demonstrated by the Agencies' impact analysis in the B3EG Proposal. See 88 Fed. Reg. at 64,168 (Table 11) (providing the Agencies' estimates that, under the B3EG Proposal, the largest U.S. banking organizations' combined Credit Risk and CVA RWAs would be more than nine times greater than revised Market Risk RWAs).

[17] See, e.g., Morgan Stanley Research & Oliver Wyman, "Into the Great Unknown," Nov. 19, 2023 (here), p. 5 ("We assess the potential implications of the US Basel 3 Endgame proposal as written, which is much stricter than global Basel 3 standards . . .").

[18] Morgan Stanley, "Strategic Update: Driving Growth Through The Next Decade," Jan. 17, 2023 (here), p. 6.

In addition, the proposed Operational Risk RWA methodology utilizes inconsistent measurement principles across different business lines. Revenue from loans and trading activities would be measured on a net basis and, in the case of loan interest income, subject to a cap while services income is effectively measured on a gross basis without any netting or cap. The gross measurement of services activities relies on U.S. GAAP revenue recognition accounting conventions that were not designed for use in regulatory capital standards and which do not incorporate directly corresponding expenses. Taken together, the distinct features of the proposed calculation for services activities—gross measurement with no netting or cap combined with accounting conventions developed for other purposes—create significant new disadvantages for these business lines and their end-user clients which are not justified or explained by analysis in the B3EG Proposal.

These issues are uniquely significant for U.S. banking organizations, which deliberately focused after the financial crisis on building services-oriented business models. Moreover, the impacts are not limited to banking organizations, but will have second-order effects on a wide and deep range of end users, in particular clients who have fewer assets and are seeking to establish advisory relationships or receive similar services. The B3EG Proposal also does not consider or analyze how the proposed application, for the first time, of the SCB to Operational Risk RWAs would result in over-calibration of capital requirements for fee- and commission-based businesses.

Proposed Market Risk RWA standards penalize diversified business models, are not rationalized with CCAR shocks, and disincentivize adoption of more accurate and risk-sensitive modeled approaches

The proposed Market Risk RWA methodology in the B3EG Proposal is based on Fundamental Review of the Trading Book ("**FRTB**") standards adopted by the Basel Committee in 2019.[19] The Agencies proposed several significant tailoring adjustments to global FRTB standards for U.S. implementation, which we support. However, as proposed, the Market Risk RWA methodology would severely limit diversification recognition across a banking organization's trading businesses, discouraging balanced business models in which periodic weaknesses in one market can be offset by strengths in others. Trading businesses would also be incentivized to reduce cross-asset class hedging practices, particularly in standardized approach Market Risk calculations, even when they provide meaningful risk management value, since such hedges would increase RWAs.

In addition, proposed standards for model-based Market Risk calculations, which in principle should be more accurate and risk-sensitive than standardized approach calculations, have features which undermine the incentives to invest in seeking model approvals. These proposed standards incorporate "non-modellable" add-ons that create significant additional RWA frictions even for diversified, balanced trading businesses and lead to capital requirement outcomes that are generally in-line with standardized based approaches. Moreover, even if a banking organization identified capital management benefits to investing in model-based calculations, banking organizations must consider the risk of "springing capital"—specifically, the risk of trading desks being unexpectedly forced off model-based calculations because of poorly calibrated model qualification standards—which may lead them to manage capital for

[19] Basel Committee, "Minimum capital requirements for market risk," Jan. 2019 (here).

trading businesses based on standardized approach calculations given uncertainties around the durability of model approvals. The financial system would be stronger if a wide range of banking organizations pursued model-based calculations to supplement mandatory standardized calculations, thereby helping to identify shortcomings in standardized calculations based on a variety of modeling approaches.

Finally, as in other areas, the introduction of significantly more conservative RWA standards raises questions about the interplay of revised RWA standards with CCAR shocks. In the wake of the financial crisis, the Board instituted market shocks in supervisory stress testing that assumed, for many trading portfolios, tail-event losses, limited diversification offsets, and long liquidation timelines. The Basel Committee developed FRTB with these same principles to correct for observed flaws in legacy Market Risk RWA standards. While the B3EG Proposal does not analyze this interplay, the Board should harmonize FRTB implementation with CCAR market shocks in any future rulemaking.

A wide range of technical issues in the proposed rulemakings raise significant concerns that require resolution to make them fit for purpose in the United States

The B3EG Proposal and G-SIB Surcharge Proposal are complex regulatory rulemakings that impact the entirety of the regulatory capital framework and, by extension, the wider U.S. economy. There are many significant design and calibration issues that have wide-ranging public policy implications. We encourage the Agencies to take a deliberate, evidence-based approach to address all these issues in any future rulemakings, including through transparent, clear rationale to justify specific calibration choices.

- Market Risk: While diversification recognition, "non-modelled" charges, and model qualification standards are central issues to be resolved in any future rulemaking, proposed Market Risk standards include a wide range of technical calibrations that have significant implications for U.S. capital markets. The calibration of "non-modelled" charges, for example, imposes higher capital requirements on positions with lower trading volumes, which is generally the case for bonds issued by smaller U.S. corporations. Resolving the treatment of these "non-modelled" charges is thus important not only for banking organizations' roles as capital markets intermediaries but also for smaller U.S. corporates' ability to raise funding efficiently and at competitive terms. Similarly impactful design and calibration issues in proposed Market Risk standards include the extent to which "residual risk" charges apply to certain market standard products used by end users for hedging and market access and whether final standards are clarified to equalize the treatment of banking organizations' positions in non-U.S. sovereign debt across trading and lending portfolios, which is important for global capital markets franchises. This summary of concerns is only partial and indicative; proposed Market Risk standards raise the largest concentration of complex technical issues in the entire B3EG Proposal, which we elaborate on more fully in our Key Comments below.

- Credit Risk: Proposed Credit Risk standards raise similar issues. Exposures to high credit quality pension funds, '40 Act funds and privately held companies would be ineligible to receive "investment grade" risk weights under proposed standards, effectively increasing the cost of credit for these entities, irrespective of their credit quality. Risk weights applied to non-significant equity investments—currently 100 percent when managed below defined thresholds—would rise fourfold for most non-publicly traded equity investments. This calibration impacts banking

organizations' investments in exchanges and clearinghouses; emerging financial technology companies; wind, solar, and other renewable energy projects; inclusive venture program investments, including those led by underrepresented entrepreneurs; and seed capital and carried interest in certain funds, all of which could have both public policy and financial system benefits. To cite only one example in this non-significant equity investments category, higher risk weights applied to seed capital and carried interest in funds significantly impacts banking organizations' asset management activities, which have important business model diversification benefits. Other significant concerns with proposed Credit Risk standards include issues related to home mortgages, to which the B3EG Proposal assigns higher risk weights than those specified by the Basel Accord (raising the cost of home ownership for U.S. residents); potential capital penalties on collateralized lending transactions, most importantly in securities borrowing markets; and disparate risk weights applied to different firms that are each subject to Basel Accord-defined capital and liquidity standards. The B3EG Proposal includes no analysis of the first- or second-order impacts of these proposed risk weights or whether the risk profiles of the exposures justify the imposition of new, higher risk weights.

- Transitions: We support a multiyear phase-in of Expanded RWAs. As proposed, however, the transition arrangements would result in mismatches with the Board's SCB framework. In concept, this mismatch arises because of the time lag between the as-of date for Expanded RWAs in CCAR (December 31 each year) and the resulting SCB based on CCAR results (applicable October 1 each year). As proposed, the Expanded RWA phase-in percentages would not align with the SCB (e.g., an SCB calibrated to 85 percent phased-in Expanded RWAs in CCAR would apply to 100 percent phased-in Expanded RWAs in Q3 2028). This mismatch does not appear to reflect a conscious policy decision in the B3EG Proposal to impose more stringent capital requirements before the completion of the phase-in period.

- G-SIB Surcharge: Despite being issued by the Board on the same day, the G-SIB Surcharge Proposal and the B3EG Proposal do not analyze their interrelationship with each other, and the G-SIB Surcharge Proposal does not provide for a phase-in to align implementation timelines with the B3EG Proposal.

Key Comments

We do not support adoption of the B3EG Proposal as a final rulemaking. Instead, we recommend that the Agencies conduct and publish for comment a quantitative analysis of regulatory capital standards applicable to large U.S. banking organizations and a related economic impact study to determine whether it is necessary and beneficial to implement the revised Basel III Accord in any form in the United States. If these analyses support a conclusion that the revised Basel III Accord would strengthen the U.S. regulatory capital framework with acceptable economic impacts, then the Agencies should prepare a revised proposed rulemaking that responds to the key concerns and key comments raised in this letter. The depth and range of concerns identified with the B3EG Proposal would be challenging to resolve in the absence of an entirely new proposed rulemaking with expanded analysis.

We support comment letters on the B3EG Proposal and the G-SIB Surcharge Proposal submitted by the various industry associations, which collectively provide a range of empirically based

recommendations informed by the interaction of the B3EG Proposal with other elements of the Agencies' prudential regulatory frameworks.[20]

We appreciate the complexity of the issues in the B3EG Proposal as well as the Agencies' need to balance a range of factors in the rulemaking process. Accordingly, in many areas of this comment letter we have suggested alternative approaches for the Agencies' consideration in any future rulemaking, as different technical approaches might achieve generally similar policy outcomes. Each of our key comments in this letter is supplemented by a technical appendix providing more detailed analysis.

CCAR/SCB Interplay

The Board adopted its CCAR stress testing program more than a decade ago and, in 2020, integrated CCAR with risk-based capital requirements by adopting the SCB final rulemaking. When adopting the SCB, the Board specifically considered the interplay of CCAR stress testing with the design and calibration of the legacy Standardized Approach, including through economic impact analysis considering the number of banking organizations that would have above-floor SCBs.[21] The B3EG Proposal includes no similar analysis, even though Expanded RWAs include a range of stress period-based calibrations and introduce two entirely additive RWA components. With this context, we recommend that the Board consider two potential implementation approaches to address the interplay of Expanded RWAs with CCAR/SCB.

First, the Board could apply Expanded RWAs at—and only at—the 72.5 percent "output floor" calibration without making them subject to the SCB. This approach would focus on achieving output floor alignment with both the revised Basel Accord and other major jurisdictions and mitigate impacts to the U.S. economy and end users. This approach would also avoid the need for considering potentially complex adjustments or recalibrations to CCAR severity assumptions, particularly in the case of operational loss projections in CCAR.

Second, if the Board elects to apply the SCB to Expanded RWAs, it should consider adjustments to reconcile the design and calibration of CCAR with the design and calibration of Expanded RWAs. Unlike the legacy Standardized Approach, Expanded RWAs include greater capture of tail risk in trading assets (similar to GMS), introduce an Operational Risk RWA component (similar to operational loss projections in CCAR) and introduce a CVA Risk RWA component (similar to CVA-style loss projections in CCAR). In concept, the Board could address this interplay either by adjusting how CCAR results are incorporated into the SCB applicable to Expanded RWAs or, alternatively, by modifying CCAR severity assumptions to harmonize them with revised RWA standards.

We appreciate that the Board intends for RWA-based requirements and CCAR to play distinct, and complementary, roles. The RWA framework defines capital requirements for banking organizations to meet throughout the economic cycle. CCAR, by contrast, measures simulated losses to determine

[20] Among other letters, we recommend specific consideration of those submitted by the Financial Services Forum, the Bank Policy Institute, the American Bankers Association, the International Swaps and Derivatives Association, the Securities Industry and Financial Markets Association, the Investment Company Institute, and the Futures Industry Association.
[21] 85 Fed. Reg. at 15,590.

whether, after a severe stress event, banking organizations would remain able to lend to households and businesses. But this distinction does not mean there is no connection between, or need to harmonize across, the two frameworks. If the Board adjusts the RWA framework to include more severe calibrations, that reduces the need to capture the same risks in CCAR. Expanded RWAs increase risk capture in the regulatory capital framework in at least three areas—Market Risk, Operational Risk and CVA—including at stress test-level calibrations in some cases, which suggests that CCAR in turn should evolve to complement these revised "baseline" RWA standards. U.K. authorities explicitly acknowledged this point when implementing the revised Basel Accord, stating that they "would not double count capital requirements for the same risks in both" revised RWAs and supervisory add-ons.[22]

Appendix 1 to this letter provides analysis and explanations in support of our CCAR/SCB interplay comments.

Operational Risk

Banking organizations face operational risks. We understand, in principle, the Agencies' goal of including a standardized Operational Risk RWA component in Expanded RWAs. The proposed Operational Risk standards, however, have three core issues that should be resolved in any future rulemaking. First, aggregate Operational Risk RWAs are much higher than highest-loss year evidence would suggest are warranted. Second, the mechanics of the services component significantly overstate actual operational risks in fee- and commission-based business models. Third, the complex Operational Risk formula—in particular, the Internal Loss Multiplier ("**ILM**") element—amplifies weaknesses in the formula when ILM is floored at 1.0. These issues are interrelated: if the services component is adjusted downward (second issue) in isolation, that has the effect of increasing ILM (third issue) since the services component is included in the ILM denominator. Any future rulemaking must consider the interplay across the elements of the Operational Risk formula to achieve a coherent, well-calibrated framework.

To address these issues, the Agencies should consider three related areas of revisions. First, the Operational Risk RWA framework should be recalibrated so that the scale of a banking organization's RWAs generally aligns with its highest recent year of operational losses. Second, the services component should utilize calculation mechanics that align with the other two components to achieve a "net" calculation of revenues and, more broadly, should be calibrated to correspond more closely to the operational loss histories and risk profiles of specific services activities. Third, the ILM element should be revised in tandem with these other changes to ensure that recalibrations in one area are harmonized with the overall formula. The table below summarizes our comments in these three areas, which might be achieved through different technical approaches. Appendix 2 to this letter provides analysis and explanations in support of these comments.

[22] Prudential Regulatory Authority, "PS17/23 – Implementation of the Basel 3.1 standards near-final part 1," Dec. 12, 2023 (here), ¶ 6.2.

Operational Risk Comment 1: Rescale Operational Risk RWAs to align with a banking organization's highest recent year of operational losses	
1: Capitalize for peak losses	• Multiply a banking organization's highest single year of operational losses incurred within the last ten years by 12.5 to scale Operational Risk RWAs.
Operational Risk Comment 2: Modify the services component to reflect the modest loss history of certain services businesses and their expense structures	
2a: Apply firm-specific profit-before-tax ("**PBT**") margins as a percentage haircut to the services component	• PBT margin-based haircuts would capture the expense structures of services businesses and thereby more closely align the design of the services component with the "net" methodologies of the interest, lease, and dividend component and the financial component.
2b: Apply variable weightings to services component business lines to reflect their specific loss histories	• Business line-specific weightings, based on industry-wide revenue and loss history data, would more accurately capture the operational risk profiles of specific services business activities (as compared with the one-size-fits-all methodology of the proposed rulemaking). • These weightings could be combined with a mechanism to net fee-based expenses and wealth management distribution costs.
2c: Cap services at 25 percent of the Business Indicator Component ("**BIC**")	• Capping the services component within BIC would address structural issues identified by Basel Committee for fee- and commission-based business models.
Operational Risk Comment 3: Set ILM at 1.0 or, alternatively, recalibrate floating ILM	
3a: Set ILM at 1.0	• Services revenues are included in the BIC, which is the denominator of the ILM formula. Accordingly, rescaling the services component (as suggested above) will cause the ILM to increase for reasons unrelated to loss history. • Setting ILM at 1.0 would neutralize this denominator effect; otherwise, revisions to the services component in isolation will be ineffective since a reduced BIC in the denominator of the ILM formula will increase ILM (and, therefore, RWAs).
3b: If ILM floats, it should not be floored, and the 15x loss history multiplier should be rescaled	• If ILM floats, it should be recalibrated to avoid increases driven solely by lower BIC in the ILM formula denominator. • Rescaling ILM in this manner should, in principle, achieve similar outcomes to setting ILM at 1.0. The exact calibration of the loss history multiplier would depend on the specific mechanism used to recalibrate the services component, as the BIC and ILM are related, dynamic elements of the Operational Risk calculation.

Market Risk

The Agencies should revise proposed Market Risk standards to improve the viability and calibration of the FRTB Internal Models Approach ("**FRTB IMA**") as well as increase cross-asset class diversification and improve a range of technical calibrations in the FRTB Standardized Approach ("**FRTB SA**").

Proposed FRTB IMA standards raise two core design issues that should be addressed in any future rulemaking. First, banking organizations may be concerned with trading desks unexpectedly failing, after initial model approvals, Profit and Loss Attribution Test ("**PLAT**") metrics. The risk of "springing capital" requirements if a trading desk is suddenly forced from FRTB IMA to FRTB SA is a major conceptual and technical impediment to broad-based pursuit of FRTB IMA. Second, the Non-Modellable Risk Factor ("**NMRF**") component of FRTB IMA is the largest single RWA driver, which should not be the case for a model-based methodology. The outsized role of NMRFs should be addressed by applying variable requirements to them based on data quality principles.

FRTB IMA Comments	
PLAT metrics should not be applied to disqualify FRTB IMA trading desks	• Banking organizations should be required to conduct, report, and publicly disclose PLAT metrics for each trading desk. • Failure of a trading desk to meet PLAT metrics, however, should not result in FRTB IMA disqualification. • PLAT metrics are novel and untested; they should be calibrated based on U.S. market evidence to reduce "springing capital" risks.
NMRFs should be distinguished based on data quality, with higher quality NMRFs included in Expected Shortfall ("**ES**")	• The NMRF framework should be revised to distinguish between low-liquidity, high-data quality NMRFs (Type A) with low-liquidity, low-data quality NMRFs (Type B) • Type A NMRFs should be included in ES calculations at a conservative liquidity horizon rather than in Stress ES ("**SES**") calculations.

There are also significant issues to resolve with proposed FRTB SA standards. Our primary comment is to recognize limited cross-asset class diversification to better reflect prudent risk management techniques and observable market data history. As proposed, the absence of any cross-asset class diversification in FRTB SA poses challenges to balanced business models. Any future rulemaking should also address the scope of the "residual risk" charges imposed through the Residual Risk Add-On ("**RRAO**")—which should have limited applicability only to circumstances where a position's risks are inadequately captured by the Sensitivities Based Method ("**SBM**")—and harmonize the treatment of banking book and trading book positions in non-U.S. sovereign debt denominated in the non-U.S. sovereign's local currency, which is important for ensuring access to capital in emerging markets.

FRTB SA Comments	
Limited cross-asset class diversification should be recognized through insertion of a new inter-asset class correlation parameter	• The FRTB SA formula should be revised to include an inter-asset class correlation parameter calibrated between 0 and 33 percent. • This would ensure that Market Risk capital requirements for individual trading businesses appropriately reflect meaningful risk-reduction from cross-asset hedging (e.g., a credit desk's use of equity put options) and incentivize banking organizations to operate balanced, cross-asset class trading businesses that are not over-concentrated in a narrow band of activities.
The applicability of the RRAO should be clarified	• The applicability of the RRAO should be clarified to confirm that it does not apply to market standard interest rate spread options, volatility swaps, variance swaps, and volatility target products.
Default capital requirement ("**DRC**") charges should include an offset for local currency liabilities	• DRC charges arising from non-U.S. sovereign debt positions denominated in the non-U.S. sovereign's local currency should be offset by a banking organization's liabilities also denominated in the same non-U.S. sovereign's local currency, following well-established banking book precedent.

While we have highlighted here a small number of specific comments, as a general matter proposed Market Risk standards raise a range of technical issues for resolution in any future rulemaking. We support other technical clarifications and adjustments in both FRTB IMA and FRTB SA proposed standards that have been raised in the constructive dialogue between the industry and Agencies in recent months. Appendix 3 to this letter provides analysis and explanations in support of our Market Risk comments.

Credit Risk

Credit Risk standards represent the largest single component of Expanded Approach RWAs and, as such, have particular significance for the U.S. economy and end users' access to credit on affordable terms. While the Agencies estimate that Expanded Approach Credit Risk RWAs will be broadly in line with existing Standardized Approach Credit Risk RWAs, this comparison excludes the effect of Operational Risk and CVA RWA requirements for the same transactions.[23] When viewed holistically, Expanded RWAs will introduce new capital constraints for banking organizations' core lending and risk management facilitation activities for end users. A summary of our key comments for revisions to proposed Credit Risk standards is provided below with additional analysis and explanations included in Appendix 4 to this letter.

[23] The economic impact analysis included in the B3EG Proposal estimate a 3 percent decline in Credit Risk RWAs when comparing the Standardized Approach and Expanded Approach. See 88 Fed. Reg. at 64,168 (Table 11). Expanded Approach RWAs are higher, however, under the Agencies' pro forma estimates if Operational Risk and CVA RWAs are included in the comparison.

Credit Risk Comments	
High-credit quality corporates should qualify as "investment grade" even without listed securities	• High-credit quality corporates—including pension funds, '40 Act funds, real estate companies, utilities, insurance companies, and privately held companies—should be eligible to qualify as "investment grade" when supported by a sufficient diligence record, regardless of whether the corporate has securities listed on an exchange.
100 percent non-significant equity investment risk weights should be retained	• A wide and diverse range of equity investments—including those in exchanges and clearinghouses; emerging financial technical companies; wind, solar and other renewable energy projects; inclusive venture program investments; and seed capital and carried interest in funds that are not Market Risk covered positions—should be eligible for 100 percent risk weights, reflecting their high credit quality as well as applicable public policy objectives.
Loan-to-value ("**LTV**")-based mortgage risk weights should be aligned with Basel Accord-defined calibrations	• Lower LTV mortgages correspond with reduced credit risk. • Application of Operational Risk charges to these mortgages obviates the need to increase mortgage risk weights to achieve parity with Standardized Approach risk weights.
The securities financing transaction ("**SFT**") haircut floor should be removed (or clarified)	• The B3EG Proposal does not cite evidence to explain why adoption of the SFT haircut floor is necessary. • If retained in a future rulemaking, the exemption in the floor for securities borrowing transactions should be clarified to more clearly exempt all such transactions categorically.
"Bank" risk weights should include exposures to nonbanks subject to Basel Accord-based standards	• Nonbanks in the UK and EU are, in many cases, subject to Basel Accord risk-based capital, leverage, disclosure, liquidity, and large exposure standards. • Risk weights should reflect the applicability of Basel Accord-based standards for these counterparty exposures.

Transitions

We support a multiyear phase-in of Expanded RWAs. Transitional arrangements for Expanded RWAs align with prior phase-in arrangements adopted by the Agencies for other significant regulatory changes and provide banking organizations with adequate time to manage toward the full application of revised standards. As explained earlier this letter, however, the proposed transition mechanics result in a mismatch between Expanded RWAs and the Board's SCB framework.

To address this problem, the Board should modify the transitional arrangements of the B3EG Proposal. A potential solution would be to apply the 2.5 percent capital conservation buffer ("**CCB**"), and not the SCB, to Expanded RWAs while continuing to apply the SCB to Standardized Approach RWAs through the full transition period, which continues until September 30, 2029. The Board might consider other approaches—such as incorporating Expanded RWAs into the SCB and G-SIB Surcharge calculations on a fully phased-in basis from the start of the transition period and aligning the phase-in date in each annual cycle for Expanded RWAs with the effective date of revised SCBs following each annual

CCAR cycle (i.e., October 1 each year)—which are explained in greater detail in Appendix 5 to this letter.

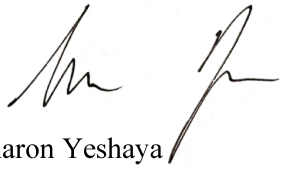
G-SIB Surcharge Proposal

The Board adopted the G-SIB Surcharge framework in 2015 based on an analysis of immediate post-financial crisis data.[24] The G-SIB Surcharge framework is complex, particularly the design and calibration of Short-Term Wholesale Funding calculations in Method 2. We support the Board's efforts to revisit the G-SIB Surcharge framework after nearly a decade of operation and encourage the Board to consider how a wide range of other prudential standards adopted since 2015 should be rationalized with this buffer. For example, the Board's calibration of the G-SIB Surcharge in 2015 relied on a historic analysis of RWA-based capital measures from 1987 to 2014.[25] The introduction of foundational changes to RWA standards in the B3EG Proposal should be paired with an assessment of whether the G-SIB Surcharge would be over-calibrated when combined with more conservative Expanded RWAs.

The G-SIB Surcharge Proposal also contemplates a significant expansion of data reporting capabilities, in particular through the shift to greater reliance on daily average values for many on-balance sheet indicators. In many cases this will require entirely new processes for producing and validating data as opposed to simply running legacy systems on a more frequent cadence. To accommodate necessary system changes, we recommend that the Board recognize a multiyear phase-in for G-SIB Surcharge changes to facilitate an orderly transition to daily average values, such as by requiring production of month-end and week-end values as an interim step before requiring production of daily values. In addition, Level 3 assets and cross-jurisdictional indicators are not well suited for daily production and should remain on a longer production cadence. Appendix 6 to this letter provides analysis and explanations in support of our G-SIB Surcharge comments.

We appreciate the Agencies' consideration of our comments on these important rulemakings.

Sincerely,



Sharon Yeshaya
Chief Financial Officer

Charles Smith
Chief Risk Officer

[24] 80 Fed. Reg. 49,082 (Aug. 14, 2015).

[25] See Board, "Calibrating the GSIB Surcharge," Jul. 15, 2015 (here), p. 7 ("First, we use historical data drawn from FR Y-9C regulatory reports from the second quarter of 1987 through the fourth quarter of 2014 to plot the probability distribution of returns on risk-weighted assets (RORWA) for the 50 largest BHCs (determined as of each quarter), on a four-quarter rolling basis.").

Appendix 1: CCAR/SCB Interplay

A. The Board should conduct an analysis of the interplay of CCAR/SCB with Expanded RWAs

The B3EG Proposal implements revisions to the global Basel Accord developed by the Basel Committee in the decade following the financial crisis. When adopting the B3EG framework in 2017, the Basel Committee described it as its "response to the global financial crisis," which was designed to address "a number of shortcomings with the pre-crisis regulatory framework."[1] The B3EG Proposal explains the proposed Expanded RWA standards in similar terms, observing that they were "developed in response to the 2007–09 financial crisis and informed by experience since the crisis" and justifying specific calibration choices with reference to financial crisis-era evidence.[2]

Before the Basel Committee completed its work in 2017, however, the Agencies had already introduced sweeping, transformative changes to the regulation of large U.S. banking organizations in response to the financial crisis. These reforms included, to name only a few examples, the adoption of annual CCAR supervisory stress testing (2010),[3] the adoption of a G-SIB surcharge framework that is significantly more stringent than global Basel Accord standards (2015),[4] the adoption of rules requiring the submission of resolution plans (2011),[5] and the adoption of enhanced prudential standards that address a range of capital, liquidity and related risks (2014).[6] In each case, the Agencies cited the financial crisis-era evidence as rationale for the new standards, underscoring their extensive efforts to construct a post-financial crisis prudential regulatory framework.[7] Accordingly, while the Basel Committee adopted the revised Basel Accord to establish an international framework responsive to financial crisis-era evidence, the Agencies had already taken significant similar strides, which have proved effective in supporting the safety and soundness of U.S. G-SIBs over the past decade, including in the 2020 and 2023 periods of economic stress.

The Agencies' broad-based efforts to strengthen post-financial crisis prudential standards culminated, in 2020, with the Board's adoption of the SCB, which integrates the results of CCAR supervisory stress tests with Standardized Approach regulatory capital requirements. The Board's impact analysis in the 2020 SCB rulemaking clearly demonstrates that it only considered how the SCB would

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[1] Basel Committee, "Basel III: Finalising post-crisis reforms," Dec. 2017, ¶ 1 (here).
[2] 88 Fed. Reg at 64,030; see also 88 Fed. Reg. at 64,063 (citing "non-bank financial entities' distress, such as [in] the 2008 financial crisis," as rationale for proposed Expanded RWA SFT standards); 88 Fed. Reg. at 64,145 (justifying proposed changes to securitization standards as being responsive to "deficiencies in the modelling of securitization positions that became more evident during the course of the financial crisis that began in mid-2007").
[3] Following the Supervisory Capital Assessment Program in 2009, the Board initiated CCAR in late 2010. See Board, "Comprehensive Capital Analysis and Review: Objectives and Overview," Mar. 18, 2011, pp. 1-2 (here). Subsequently, the Board promulgated formal CCAR standards. See 77 Fed. Reg. 62,378 (Oct. 12, 2012).
[4] 80 Fed. Reg. at 49,082.
[5] See 76 Fed. Reg. 67,323 (Nov. 1, 2011); see also 84 Fed. Reg. 59,216. (Nov. 1, 2019) (modifying the requirement to a biennial submission).
[6] 79 Fed. Reg. 64,049 (Oct. 27, 2014).
[7] See, e.g., 80 Fed. Reg. at 49,090 (citing "industry-wide stress such as occurred during the 2007–2008 financial crisis" as providing "further support for setting the cut-off line for [G-SIB Surcharge] method 2 at the lower end of the target range").

impact firms' capital capacity and capital management under Standardized Approach RWA-defined requirements. After explaining its rationale for applying the SCB in only the Standardized Approach, the Board observed that the SCB "significantly changes how stress tests factor into capital requirements," which may result in firms "chang[ing] their approach to management buffers in response to the rule."[8] The Board further explained that it "examined the impact of the [SCB] rule on risk sensitivity," and that "firm-by-firm data across supervisory stress test exercises from 2013 to 2019" allowed the Board to estimate that "about half of the observations would have a stress capital buffer requirement above 2.5 percent.[9] All of this analysis was focused on, and limited to, how the SCB would interact with the Standardized Approach.

Notably, there is no similar analysis in the B3EG Proposal. While the proposal summarizes the significant anticipated increase in RWAs in the Expanded Approach, there is no analysis of how application of the SCB to Expanded RWAs might cause firms to change their approaches to management buffers, the impact of the SCB on "risk sensitivity" under Expanded RWAs, or even estimates of whether the number of firms operating above the SCB floor of 2.5 percent might change. This absence is striking, given the Agencies' decade-plus effort to develop post-financial crisis prudential standards and the detailed, explicit analysis of the interplay of the SCB and RWAs included in the Board's 2020 SCB rulemaking.

Before adopting a final rulemaking, we believe the Board should analyze the interplay of CCAR/SCB with Expanded RWAs. Such analysis is necessary to consider how Expanded RWAs should be implemented to complement the extensive post-financial crisis prudential standards already adopted by the Agencies. In addition, an analysis focused on Expanded RWAs is also necessary to update the Board's 2020 analysis of how the SCB modifies RWA-defined regulatory capital standards. Finally, an analysis would allow the Board to refine the B3EG Proposal to reduce over-calibration of risk capture between CCAR/SCB and Expanded RWAs.

B. The SCB, in its current form, is not harmonized for application to Expanded RWAs

We appreciate that the Board intends for RWAs and CCAR/SCB to play distinct roles in the regulatory capital framework. We understand that RWA-based capital requirements define general regulatory capital minimums. By contrast, supervisory stress testing assesses whether a banking organization would be able to manage through a severe crisis while continuing to meet its general regulatory capital minimums and, thereby, continue to provide credit to the economy and function as a capital markets intermediary. By design, a supervisory stress test such as CCAR—and the resulting SCB derived from the stress test's results—should, in principle, result in capital requirements that are additive to generally applicable RWA-based regulatory capital minimums.

Any stress test, however, rests on specific design and calibration choices. A stress test premised on a five percent increase in the unemployment rate will, all else being equal, result in less severe assumptions than a stress test premised on a twenty-five percent increase in the unemployment rate. The

[8] 85 Fed. Reg. at 15,590.
[9] Id.

Board's CCAR policy statements address this fact by including, for example, quantitative guidance on the calibration of unemployment rate assumptions that will inform the macroeconomic component of supervisory stress testing.[10] In other words, as currently applied, the Board calibrates CCAR severity assumptions to target levels to achieve specific prudential policy objectives. Changes in circumstances—including changes in economic conditions, macroprudential objectives, or the regulatory framework—might reasonably lead to a recalibration of CCAR severity assumptions in response.

The B3EG Proposal introduces significant changes to the risk-based capital framework, including through greater capture of tail risk in trading assets (Market Risk) and incorporation of two entirely new risk components (Operational Risk and CVA). We understand the logic of applying stress testing to the new RWA framework; as is currently the case, stress testing can help confirm that banking organizations would be able to meet their point-in-time capital requirements even after a major shock. However, stress testing assumptions should be reconsidered and updated dynamically to work in tandem with changes in the RWA framework. If Expanded RWAs reflect a more comprehensive capture of potential risks—as is suggested by the resulting increase of RWAs as compared with the Standardized Approach—then CCAR should be retooled in response to ensure that supervisory stress test assumptions are complementary. There are at least three reasons for doubting that CCAR, in its current form, is fit-for-purpose when applied to Expanded RWAs.

First, the application of the SCB to Operational Risk RWAs would result in two different mechanisms for capitalizing against operational risks. Consistent with current practice, the SCB would impose a ratio requirement that reflects the Board's operational loss projections in CCAR. In addition, inconsistent with current practice, the CCAR-defined SCB ratio requirement would then be applied to RWAs that include Operational Risk RWAs calibrated to achieve capitalization for 15 years of losses. After administering CCAR for more than a decade without combining CCAR-estimated operational losses and Operational Risk RWAs, combining them together in the future raises both conceptual and technical questions around the over-calibration of operational risk capture in the regulatory capital framework, including what optimal capital level the 15-year RWA calibration and undefined time horizon of CCAR estimates is meant to achieve.[11] While the analysis is more nuanced, the same general problem arises from application of the SCB for the first time to CVA RWAs.

Second, the calibration of specific CCAR standards replicates, in some areas, similar calibrations included in Expanded RWAs. This is most clearly evidenced in the trading book, as explained in Appendix 2 in this comment letter. In summary, the GMS component of CCAR includes specific technical assumptions—longer liquidity horizons, more extensive capture of tail risks, limited diversification benefits—that are broadly similar to those included in FRTB.[12] In fact, when adopting the

[10] See 12 C.F.R. Part 252 Appendix A, Section 4.2.2(a) (explaining how the Board sets the unemployment rate under the severely adverse scenario).

[11] While the CCAR projection period is nine quarters, the Board's CCAR policy statements do not describe the methodology used to calculate projected operational losses, including whether they reflect baseline expected operational losses over nine quarters or, like GMS, reflect losses that might arise over a longer time horizon that are compressed for purposes of the projection period. See 12 C.F.R. Part 252, Appendices A, B.

[12] See 12 C.F.R. Part 252 Appendix A, Section 3.2. (noting that GMS simulates shocks that "might typically be observed over an extended period (e.g., 6 months)," which incorporates a long liquidity horizon); Section 5.2.3(b) (explaining how the GMS captures tail risks by utilizing 2008-era market evidence because "developments in the

FRTB global standard in 2019, the Basel Committee cited the need for longer liquidity horizons, more extensive capture of tail risk and limited diversification benefits as rationale for revising Market Risk RWAs.[13] While the extent of this overlap varies by asset class, to a substantial extent each of GMS and FRTB separately respond to perceived weaknesses in legacy Market Risk RWA standards with solutions in each case calibrated based on financial crisis-era empirical evidence.

Third, firms manage their capital requirements to the greatest extent possible by considering all relevant requirements. In the current framework, a banking organization may allocate capital to a trading desk, for example, by combining RWA framework-based requirements and GMS-implied requirements to reach a total requirement. This total requirement is then used by the trading desk to determine its capital return hurdle rate, impacting the extent to and price at which it can engage in market making and support clients' hedging needs. All else being equal, increasing RWA framework-based requirements while leaving GMS-implied requirements unchanged will increase, in this example, the trading desk's total requirement, reducing its capacity. Accordingly, the minimum-versus-buffer distinction begins to break down when capital requirements are applied directly to businesses.

We recognize that there is considerable complexity in the Board's regulatory capital framework, particularly at the intersection of CCAR, the SCB and evolving RWA standards. Accordingly, in the remainder of this Appendix, we have suggested several different technical approaches that the Board might consider to address the interplay of CCAR and Expanded RWAs. While each of these approaches raises distinct considerations, we respectfully request that the Board consider each of them in connection with analysis supporting any final rulemaking.

C. Implementing the revised Basel Accord only as an "output floor," without application of the SCB, should be considered

The Board might consider several solutions to harmonize the SCB and Expanded RWAs. While there is inherent complexity in most potential approaches, there is one simple approach that would achieve closer alignment with other major jurisdictions: apply Expanded RWAs at the 72.5 percent "output floor" without application of the SCB.

1. The output floor-focused approach would better achieve global harmonization

The Basel Committee "did not intend [for] the proposal to require banks to hold more capital."[14] The B3EG Proposal, by the Agencies' own quantitative estimates, does precisely this by adding an estimated $1.8 trillion in RWAs to Category I and II holding companies' risk-based capital

credit markets [at that time] were unprecedented" and "key risk factors in virtually all asset classes experienced extremely large shocks"); and Section 5.2.3(d) (providing the Board with discretion to limit historical diversification evidence through GMS risk factors that "may be amplified based on theoretical relationships, market observations, or the saliency to company trading books").

[13] Basel Committee, "Explanatory note on the minimum capital requirements for market risk," Jan. 2019, pp. 3-4, 6-7.

[14] Congressional Research Service, "Bank Capital Requirements: Basel III Endgame," Nov. 30, 2023, p. 16 n. 54 (here).

requirements.[15] Focusing on the output floor as a standalone update to the U.S. regulatory capital framework would advance the core objective of the revised Basel Accord by ensuring globally consistent minimum standards while mitigating the projected capital impact on large U.S. banking organizations and, by extension, the U.S. economy.

The output floor is incorporated in the B3EG Proposal through the definition of "expanded total risk-weighted assets," which is defined as the "greater of" Expanded RWAs (inclusive, as applicable, of FRTB IMA RWAs) at 100 percent calibration and Expanded RWAs (inclusive of FRTB SA, not FRTB IMA, RWAs) at 72.5 percent calibration.[16] In practice, however, the 72.5 percent calibration prong of this definition appears largely to be a formality. To be bound by the 72.5 percent calibration prong, a banking organization would need to have both comparatively large Market Risk RWAs and have approvals to use FRTB IMA in manner that would result in aggregate Expanded RWAs that are at least 27.5 percent lower than all-standardized aggregate Expanded RWAs. Based on these criteria, no U.S. banking organization appears to be reasonably likely to be bound by it.

This analysis is different in the U.K. and European Union, where ongoing permission in their B3EG implementation frameworks for banking organizations to model Credit Risk RWAs might reasonably lead to circumstances where an all-standardized Expanded RWA 72.5 percent output floor is binding for certain institutions. By contrast, the Agencies' decision to eliminate modelled Credit Risk RWAs—by far, the largest single RWA component—renders the output floor largely moot as a potential binding constraint for U.S. banking organizations.

Therefore, revising the definition of "expanded total risk-weighted assets" to include only the second, 72.5 percent calibration prong would more clearly advance global harmonization. U.S. banking organizations would remain subject to the Standardized Approach—as updated for FRTB and with ongoing application of the SCB—but would also be required to comply with an output floor aligned with both the Basel Accord and the general operation of U.K. and European Union implementations.

2. Application of the SCB to Expanded RWAs is unnecessary

The SCB is a unique feature of the U.S. regulatory capital framework that is not included in the Basel Accord. Accordingly, an implementation of the Basel Accord focused on international harmonization would not include application of the SCB to Expanded RWAs.

Application of the 2.5 percent CCB, not SCB, to Expanded RWAs would also align with the Board's current regulatory capital framework in which the SCB applies to the Standardized Approach but not Advanced Approaches RWAs. As explained earlier in this letter, the Board's analysis in its 2020 SCB final rulemaking was limited to consideration of how CCAR-based SCB requirements would apply in the Standardized Approach,[17] and the Board specifically elected to not apply the SCB in the Advanced Approaches. There is no statutory or regulatory requirement that that the SCB must apply to Expanded

[15] 88 Fed. Reg. at 64,168 (Table 11).
[16] 12 C.F.R. § 217.2 (proposed).
[17] See 85 Fed. Reg. at 15,590 (acknowledging that "the [SCB] final rule significantly changes how stress tests factor into capital requirements" and summarizing the Board's impact analysis, which was necessarily limited to impacts under the Standardized Approach framework).

RWAs; more than a decade of regulatory and supervisory practice suggests that application of CCAR-based capital requirements to the Standardized Approach is sufficient.

D. Application of the SCB to Expanded RWAs would require harmonization across the two frameworks

The Board designed and calibrated the SCB framework to apply to the Standardized Approach. Given this context, if the Board elects to apply the SCB to Expanded RWAs, it should analyze the interplay of CCAR severity assumptions with Expanded RWAs and consider adjustments to the regulatory framework to harmonize revised RWA standards with the stress testing framework. Based on this analysis, we recommend that the Board consider two distinct approaches for how this harmonization might be achieved: one focused on adjustments to the SCB framework and a second focused on adjustments to CCAR severity assumptions.

1. SCB modification approach

If the Board elects to apply the SCB to Expanded RWAs, it might consider adjusting how the SCB incorporates CCAR results to reduce over-calibration of risk capture. Under this approach, the operation of annual CCAR exercises would remain unchanged, but projected start-to-trough declines in supervisory stress test projection period capital ratios would be adjusted when "translated" into resulting SCBs. While more technically complex than applying a 2.5 percent CCB to Expanded RWAs, this approach would rely on two mechanisms, each of which could be defined narrowly to achieve a targeted objective.

First, the Board could remove the effect of trading book GMS losses from the first quarter of the projection period when calculating SCBs. This adjustment would be limited to trading book GMS losses, exclusive of GMS impacts to banking book private equity positions, which are not subject to FRTB. This approach would be relatively simple to implement, as it would impact a single quarter of the CCAR projection period using a category of losses already calculated by the Board. It would also be narrowly tailored to address trading book-specific over-calibration issues arising from the methodological similarities between FRTB and GMS.

Second, the Board could reverse the effect of operational losses in PPNR projections when calculating the low-point capital ratio in the CCAR projection period. Again, this should be relatively simple to implement; since the Board calculates quarter-by-quarter PPNR estimates inclusive of operational losses, it could simply remove the operational losses from these estimates when calculating low-point projected ratios for the SCB. This mechanic would be narrowly tailored to address the over-calibration of risk capture resulting from the combination of Operational Risk RWAs and operational loss projections.

Several additional considerations support this approach:

- While the effect of these adjustments cannot be analyzed fully based on existing CCAR public disclosures, the Board could implement this approach with a cap or similar mechanism designed to limit these two adjustments if they produce outsized results.

- The SCB would continue to apply to Standardized Approach RWAs without adjustment, ensuring that SCB-defined capital requirements would remain as conservative as today (even before giving effect to inclusion of FRTB in the Standardized Approach).

- The Board reproposed the SCB mechanics for comment in the B3EG Proposal, providing a direct procedural mechanism to implement this approach.[18]

- The Board could implement this approach without making any changes to its CCAR framework, including the continued publication of unadjusted projected capital ratio declines in annual disclosures of supervisory stress test results.

2. CCAR severity assumption modification approach

Finally, the Board might address over-calibration of risk capture by moderating the severity of CCAR assumptions. Similar to the SCB adjustment mechanisms summarized in Section D.1 of this Appendix 1, this approach would also focus on GMS impacts and operational loss estimates. However, unlike as with SCB adjustments, this approach would involve making changes directly to CCAR. We think there are several reasons to consider this approach.

First, revising the severity of CCAR assumptions—at least for GMS and operational loss projections—would demonstrate the ongoing, dynamic nature of the Board's supervisory program in response to related changes in the regulatory framework. While CCAR is a well-established program, it should remain subject to ongoing reassessment to ensure it is fit for purpose and tailored to best advance the Board's policy objectives.

Second, the Board's existing CCAR policy statements provide it with extensive discretion to modify and evolve CCAR scenarios as warranted by economic and regulatory circumstances. CCAR policy statements impose only limited constraints on specific quantitative assumptions in supervisory stress tests,[19] providing the Board with a potential path to revisit GMS and operational loss severity.

Third, application of the SCB to Expanded RWAs would reduce the underlying policy rationale for the current calibration of GMS and operational loss projections. If risks from these two areas are separately capitalized for in revised RWA standards, the original rationale for severe assumptions in CCAR in these two areas is considerably weakened.

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[18] 88 Fed. Reg. at 64,326.

[19] The Board's Policy Statement on the Scenario Design Framework for Stress Testing imposes quantitative limitations unemployment rate and housing price assumptions in supervisory stress testing scenarios. See 12 C.F.R. Part 252 Appendix A, Sections 4.2.2 and 4.2.3. Similar quantitative constraints do not apply for GMS severity or operational loss estimates.

Fourth, the Board's stated policy objective of using simple approaches in supervisory modeling, where possible, would support revisiting severity assumptions in CCAR. As discussed earlier in this Appendix, the introduction of Operational Risk and CVA components to the RWAs subject to CCAR/SCB adds both conceptual and technical complexity to SCB-based capital requirements. Adopting adjustments to CCAR severity assumptions—including, for example, new principles for calculating operational loss projections or GMS shocks—provide an opportunity to simplify the framework, allowing the Board to "select the least complex modeling approach."[20]

Fifth, the Board could implement changes in CCAR over an extended period during the Expanded RWAs transition period to ensure that, by 2029, any SCB applied to Expanded RWAs reflects updated analysis and supervisory experience. In particular, if the Board applied a 2.5 percent CCB to Expanded RWAs during the transition period, that would provide it with time to consider evidence from a range of exploratory scenarios before making adjustments to GMS and operational loss projections once the SCB is ultimately applied to Expanded RWAs. This approach would ensure that the Board has adequate time to resolve CCAR harmonization issues and avoid potentially significant and disruptive spikes in capital requirements before the harmonization exercise is completed.

In practice, adjustments to CCAR severity assumptions might include:

- Shorten the liquidity horizons used for calibrating GMS shocks when impacted trading book positions are already subject to conservative FRTB requirements based on longer liquidity horizons. This modification would, in effect, tailor the GMS shocks to complement FRTB calibrations for the same products.

- Reduce estimates of operational losses included in the Board's PPNR estimates in the supervisory stress test projection period in response to the introduction of Operational Risk RWAs in the capital ratio included in CCAR. For example, if historic CCAR exercises for a banking organization assumed $10 billion in projected operational losses in the CCAR projection period, that figure would be reduced to account for capitalization against the same operational risks achieved through Operational Risk RWAs.

    - Our recommendation in this area is illustrative since the Board's CCAR disclosures do not include granular explanations of operational loss projections. However, in principle, it appears logical to moderate operational loss projections in specific areas that would, for the first time, become subject to RWA-based capital requirements included in CCAR.

[20] 12 C.F.R. Part 252 Appendix B, Section 1.4.

Appendix 2: Operational Risk

The design and calibration of the Operational Risk RWA framework is one of the most significant issues in the B3EG Proposal. By the Agencies' estimates, roughly 78 percent of the RWA increase between the Standardized Approach and the Expanded Approach is driven solely by the addition of Operational Risk RWAs as a new RWA component.[1] Notably, however, the B3EG Proposal does not analyze whether or to what extent the absence of Operational Risk RWAs in the Standardized Approach has led to under-capitalization for operational risks at large U.S. banking organizations or what effect the addition of new Operational Risk RWAs will have on business lines with modest credit risk and market risk profiles, such as wealth management and asset management.

We believe that the Agencies should tailor the Operational Risk RWA framework for application to U.S. banking organizations, which have much larger fee- and commission-based revenue streams than global peer banks. This tailoring could be achieved by calibrating Operational Risk RWA standards to achieve capitalization of a banking organization's largest recent year of operational losses or by targeted adjustments to the services component to introduce a netting or capping mechanism or more granular business line-specific adjustments. Adjustments in a final rulemaking should be calibrated to reflect evidence of lower operational risk profiles in the services activities of large U.S. banking organizations.

A. Operational Risk capital standards impact end users across a diverse range of businesses

The B3EG Proposal would apply Operational Risk RWAs to the entirety of a banking organization's business activities. The B3EG Proposal does not analyze the economic impact of adding an estimated $1.4 trillion in RWAs in this category to U.S. G-SIBs' Expanded Approach requirements. Since a banking organization must allocate capital to meet the regulatory capital requirements of its activities, large U.S. banking organization will have to reconsider their products and services in some areas and refocus their business strategies in response.

In practice, the impacts from new Operational Risk RWAs may be most apparent in high-volume, low-margin fee- and commission-based businesses that traditionally give rise to modest Credit Risk and Market Risk capital requirements. In practice, a banking organization with a large client population may decide to raise fees or commissions to meet its increased capital hurdle, particularly for client segments that are considered less profitable. All else being equal, these pressures may be most felt by retail client populations, including clients in early stages of wealth accumulation who could benefit from sustained advice and engagement.

An economic impact analysis focused on Operational Risk RWAs would consider, for instance, the relative profitability of specific business activities and a banking organization's capital hurdle under revised standards. We do not expect that the introduction of new Operational Risk RWAs will, by itself, cause banking organizations to exit major business lines. However, banking organizations will be required to adjust and "right size" their suite of products and services. A thoughtful and complete

[1] 88 Fed. Reg. at 64,169.

economic impact analysis would consider these marginal capital costs and impacted client populations across wealth management, asset management, custodial, underwriting, client clearing and credit card business lines.

B. The services component of proposed Operational Risk RWA standards does not accurately capture the risk profiles of fee- and commission-based business models, particularly asset and wealth management franchises

Under the B3EG Proposal, Operational Risk RWAs would be calculated through three Business Indicator components: an interest, lease, and dividend component; a financial component; and a services component. The first two components are designed to capture a banking organization's revenue streams on a net basis, since income (e.g., interest income) is offset by expenses (e.g., interest expense). In other words, the calculations for the interest, lease, and dividend component and financial component incorporate at least some of the direct costs associated with in-scope business lines' revenues.

By contrast, the services component utilizes the greater of a banking organization's fee and commission income or expenses, which is then added to the greater of a banking organization's other operating income or other operating expense. This "greater of" mechanic in the services component leads to three related problems.

First, the proposed Operational Risk framework is not internally consistent. Two of the three components rely on "net" measures of profitability, whereas the third uses a gross measure of income and expenses. The resulting combined Business Indicator for the entire banking organization does not reflect a consistent starting point of relevant inputs. The B3EG Proposal explains that a gross approach is necessary for the services component as it "would account for the different business models of banking organizations better than a netting approach, which may lead to variances in the services component that exaggerate differences in operational risk."[2] This statement is only explained, however, through a brief discussion of differences between distribute-only versus originate-to-distribute business models, whereas the services component would apply in practice to a wide range of fee- and commission-based business models. This core design choice—and the resulting inconsistency with the two other components—is not otherwise analyzed or explained.

Second, the proposed Operational Risk standards appear to be based on the premise that all forms of services component income (or expenses, if greater) give rise to equivalent levels of operational risk. The gross approach does not, for example, apply different calibrations to reflect the extent to which a given business line's income (or expenses) may lead to higher or lower operational risks when compared with those of another business line; all income is equally risky. Empirical evidence shows, however, that the relationship between income and operational losses is highly variable. Operational Risk Consortium ("**ORX**") data from 105 banking organizations over 21 years suggests, for example, that loss rates per dollar of income vary by a factor of up to three across major business lines.[3] This analytical conclusion should not be surprising, given that the services component captures such diversified and disparate

[2] 88 Fed. Reg. at 64,084.

[3] O.R.X., "Basel III and standardised approaches to capital Analysis of ORX global banking data in response to regulatory reforms," Oct. 2023 (the "**ORX Report**") (here), p. 5.

activities as asset management, custodial services, wealth management, client clearing and credit cards. Empirical evidence showing a lower historical loss rate for asset management, for example, should influence the design and calibration of any Operational Risk final rulemaking.

Third, the gross measure of income (or expenses) and uniform weighting of all services revenues leads to particularly striking outcomes when the proposed Operational Risk RWA framework is applied to business activities with modest credit risk and market risk. Morgan Stanley, for instance, has deliberately grown fee- and commission-based businesses since the financial crisis, with wealth management and asset management now contributing more than half of our total profits.[4] Stable, through-the-cycle fee- and commission-based revenues provide recurring and durable income streams to large banking organizations. In its current design, however, the proposed Operational Risk standards introduce a capital disincentive to grow these activities further, since incrementally higher fee- and commission-based income would lead to higher RWAs, regardless of whether the income arises from activities with higher operational risk profiles.

C. U.S. banking organizations are uniquely impacted by the design and calibration of Operational Risk standards, justifying a tailored approach

Publicly available evidence demonstrates that U.S. banking organizations have much more significant fee- and commission-based revenues than their global peers.[5] The prevalence of high services revenues at large U.S. banking organizations is not evidence of weakness in the system; instead, it is evidence of resilience. European regulators, in fact, have voiced their desire for European banks to develop similar fee- and commission-based business models.[6]

While grounded in a global Basel Accord, the implementation of the services component of Operational Risk in the United States thus raises unique considerations that do not apply (or do not apply in equal measure) in other jurisdictions. The B3EG Proposal indirectly alludes to this by including a question asking whether the Agencies should consider "alternatives" to calculating the services component, including based on "any impacts on specific business models."[7]

We believe that the Agencies should consider alternative approaches. The methodological shortcomings of the calculation become amplified when applied to the business models of large U.S. banking organizations. This is not an edge issue where global uniformity in a technical standard would foster generally equivalent outcomes across major jurisdictions; rather, applying the services component as proposed to U.S. banking organization would introduce significant obstacles causing uniquely outsized impacts.

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[4] Morgan Stanley, "Strategic Update: Driving Growth Through The Next Decade," Jan. 17, 2023, p. 6 (here).
[5] See, e.g., Bank Policy Institute, "A Modification to the Basel Committee's Standardized Approach to Operational Risk," May 4, 2022 (here).
[6] See, e.g., European Central Bank Vice-President Luis de Guindos, "Challenges for bank profitability," May 1, 2019 (here) ("Developing sustainable revenue streams beyond net interest income – such as fee and commission income – remains vital in order to buttress profitability in the coming years.").
[7] 88 Fed. Reg. at 64,084 (Question 74).

D. The Basel Committee itself highlighted shortcomings in its development of the Operational Risk framework

The case for tailoring the Operational Risk framework to make it fit-for-purpose in the United States is also supported by the procedural record of the Basel Committee, which highlighted concerns with the services component but did not ultimately adopt a solution to the concerns it identified.

The Basel Committee issued two post-financial crisis consultative papers to develop the Operational Risk RWA framework.[8] The 2014 Ops Risk Consultation observed:

> A small number of banks that are highly specialised in fee businesses have been identified as facing a disproportionately high capital impact under the BI. The problem stems from the structure of the BI, which was designed to capture the operational risk profile of a universal bank and does not lend itself to accurate application in the case of banks engaged predominantly in fee-based activities. The Committee will respond to the issue if it is evidenced by the results of the new data collection exercise.[9]

Two years later, in the second consultation, the Basel Committee reiterated this concern, explaining that under the 2014 proposed standard "banks with a high fee component in respect to the overall BI amount have a very high BI value which results in capital requirements that are too conservative relative to the operational risk faced by these banks." The 2016 Ops Risk Consultation proposed several technical fixes, including a new modification that would reduce recognition of services revenues in the Operational Risk calculation for "high fee banks."[10]

The Basel Committee did not resolve these issues when adopting the revised Basel Accord in 2017. The final 2017 standard did not adopt the mechanism proposed in 2016 or include any commentary explaining why or how the Basel Committee had determined that the final Operational Risk framework appropriately captured the operational risks in high fee banks. This unusual procedural background—identifying a problem, proposing a solution, and then neither adopting the proposed solution nor offering any explanation for the non-adoption—underscores the need to adjust the Operational Risk framework for U.S. implementation. It is also noteworthy that the Basel Committee described, in 2014, the interest, lease, and dividend component as the "dominant component" in the entire Business Indicator calculation, which may suggest why resolving the services component issues was not prioritized, even if they are highly impactful to U.S. banking organizations.[11]

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[8] Basel Committee on Banking Supervision, "Consultative Document: Standardised Measurement Approach for operational risk," Mar. 2016 ("**2016 Ops Risk Consultation**") (here); Basel Committee on Banking Supervision, "Consultative Document: Operational risk - Revisions to the simpler approaches," Oct. 2014 ("**2014 Ops Risk Consultation**") (here).

[9] 2014 Ops Risk Consultation, ¶ 46.

[10] 2016 Ops Risk Consultation, ¶ 20.

[11] 2014 Ops Risk Consultation, p. 3.

E. The calibration of Operational Risk RWA standards to achieve fifteen years of capitalization is unwarranted and unsupported by analysis

The Operational Risk RWA formula includes a calculation element that is calibrated to capture fifteen years of operational losses.[12] The Basel Committee's procedural record is unclear as to why it adopted a fifteen-year calibration. Legacy Operational Risk standards, including the Agencies' 2007 Basel II final rulemaking, do not incorporate any feature designed to achieve capitalization for a specific timespan of operational losses.[13] The Basel Committee's 2014 consultation included an annex summarizing "the 'OpCaR calculator,'" which it described as "the methodology developed by the Committee to estimate a bank's operational risk capital-at-risk" and relied on five years of operational loss data (2005-2009).[14] Following this, the 2016 consultation defined the loss component as a seven-year window (with higher loss events amplified in the formula if within a five-year window).[15] The Basel Committee included the fifteen-year calibration in its final 2017 Operational Risk RWA framework without explanation.[16]

The absence of clear rationale for using a fifteen-year calibration is notable. There is no other standard in the U.S. prudential regulatory framework that uses a similar time horizon; even long-dated measures of financial resilience generally use a one- or two-year framework of reference.[17] The B3EG Proposal does not include analysis explaining why a fifteen-year time horizon is appropriate for Operational Risk capitalization, such as an analysis demonstrating that the magnitude or frequency of operational loss events across the U.S. banking industry supports such a calibration. A fifteen-year time horizon also appears to assume that a banking organization will suffer, year after year, operational losses with no accretion of capital, even though the post-financial crisis period demonstrated that the U.S. G-SIBs accreted significant capital in the years following the crisis.[18]

Our concerns with the fifteen-year timespan assumption are further amplified by the window of operational loss evidence considered by the Basel Committee when developing the global Basel Accord. The Basel Committee's disclosures indicate that it considered evidence through 2016 when developing the 2017 final standard.[19] Evidence from the initial years following the financial crisis reflect industry-

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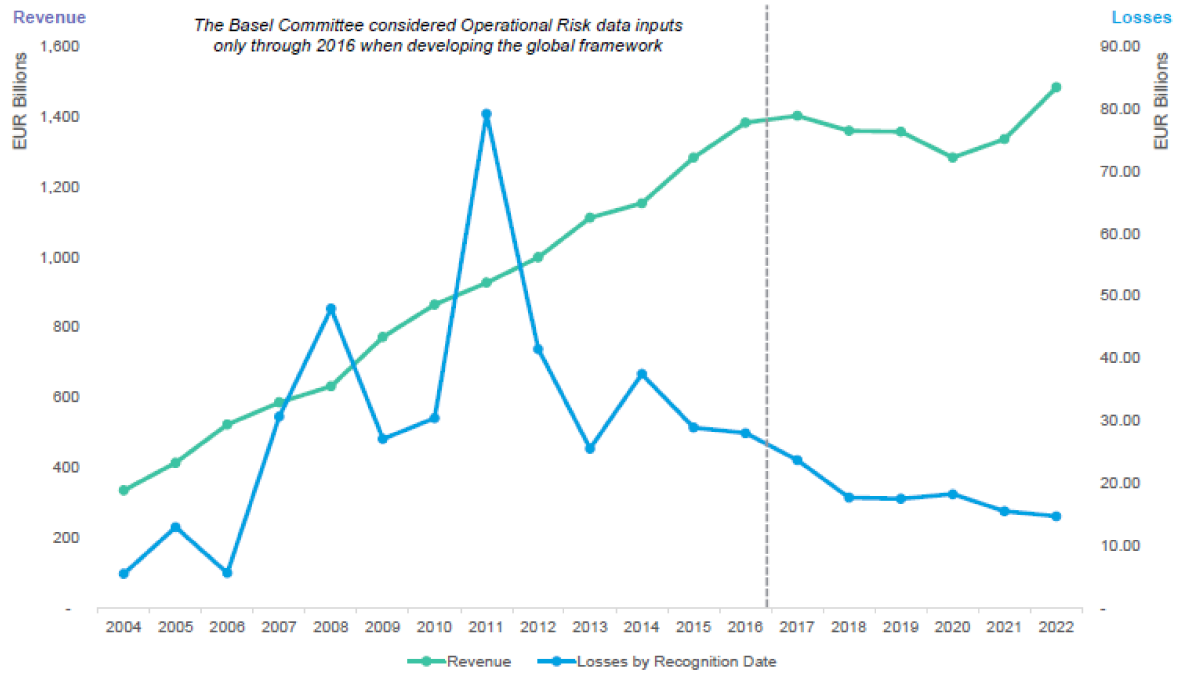
[12] In practice, the B3EG Proposal achieves 15-year capitalization by multiplying average annual total net operational loss from a 10-year window by 15. See 12 C.F.R. § 217.150(e)(1) (proposed).
[13] See 72 Fed. Reg. 69,288 (Dec. 7, 2007).
[14] 2014 Ops Risk Consultation, Annex 2, ¶ 1.
[15] 2016 Ops Risk Consultation, ¶ 35.
[16] Basel Committee, "Minimum capital requirements for operational risk," Dec. 2017, ¶ 9.
[17] See, e.g., 86 Fed. Reg. 9120, 9122 (Feb. 11, 2021) (explaining that the Net Stable Funding Ratio "requires banking organizations to maintain a stable funding profile over a longer, one-year time horizon"); 12 C.F.R. § 252.62(b)(1)(i) (including, at 100 percent value, "the amount due to be paid of unpaid principal of the outstanding eligible debt securities issued by the global systemically important BHC [when maturity is] greater than or equal to 730 days (two years)").
[18] Board, "Financial Stability Report," May 2023, p. 37, Figure 3.3. (here).
[19] Basel Committee, "Finalizing Basel III: In brief," Dec. 2017 (here), p. 6 (summarizing operational risk loss evidence considered by the Basel Committee through 2016). Year-by-year comparisons of operational losses cited by the Basel Committee and ORX are not fully aligned. In the ORX data, the peak loss year was 2011 whereas the peak loss year in the Basel Committee record is 2014. Notwithstanding differences in loss recognition standards and data inputs, the general trend of a post-financial crisis spike in operational losses is consistent in both analyses.

wide growth in both revenues and operational losses, as reflected in the chart below. By 2017, however, continued growth in revenues was not paired with corresponding growth in operational losses. Accordingly, the foundational logic of the Basel Committee's approach—that revenues are an accurate proxy for operational losses—is not supported by industry-wide evidence from the past six years. While the evidence below is based on ORX data that includes submissions from bank and nonbank industry participants, it suggests that revenues and operational losses are not strongly correlated.

Chart: ORX Industry Losses and Revenue (2004-2022)[20]



F. Large banking organizations have greater capacity to manage operational risks

The proposed Operational Risk RWA standards include a mechanic that increases capital requirements at a higher rate as banking organizations generate greater business volumes.[21] The B3EG Proposal justifies this approach by asserting that "banking organizations with higher overall business volume are larger and more complex, which likely results in exposure to higher operational risk," citing to academic research.[22] The B3EG Proposal does not justify the calibration of these standards, however, with reference to publicly disclosed summaries of supervisory data.

Even if the assertion that higher business volume is correlated with higher operational risk is accurate, it is an incomplete foundation for setting Operational Risk capital requirements, as larger

[20] Morgan Stanley analytics based on ORX source data. ORX membership grew between 2004 and 2022, so composition of data-reporting firms is not constant in time series.
[21] The Operational Risk RWA formula applies progressively higher charges to higher business indicators, with step-ups at $1 billion and $30 billion thresholds. See 88 Fed. Reg. at 64,085-86.
[22] 88 Fed. Reg. at 64,083 & n. 178.

banking organizations also have greater capacity to invest in operational risk management. A clear example of this point is cyber-security, which the Board recently identified as a near-term supervisory priority.[23] Banking and capital markets companies have spent more on cybersecurity as a percentage of revenue in recent years (0.88 percent in 2021 and 0.80 percent in 2023 vs. 0.30 percent in 2019).[24] Sector-wide, financial services companies spent about 10 percent of their IT budget on cybersecurity in recent years.[25] For large financial institutions, the significant investments in this area reflect the high priority they give to cyber-security risk management.[26]

Finally, even if the B3EG Proposal's assertion is accurate that larger U.S. banking organizations have, on balance, greater operational losses, that still leaves unresolved how to measure "largeness" for these purposes. The proposed Operational Risk RWA standards effectively use revenue as a measure of "largeness." The Board's prudential framework, however, includes other measures of a banking organization's size and scale, including total consolidated assets,[27] total leverage exposure[28] and the G-SIB Surcharge framework,[29] to name a few examples. While a revenue-focused measure captures business activities that have modest balance sheet asset footprints, the B3EG Proposal does not include analysis to support a conclusion that it is an accurate proxy for operational risk-relevant size and scale.

G. Operational Risk RWA recommendations

Our comments have identified three core issues in proposed Operational Risk RWA standards. First, aggregate Operational Risk RWAs are much higher than highest-loss year evidence would suggest are warranted. Second, the mechanics of the services component significantly overstate actual operational risks in fee- and commission-business models. Third, the complex Operational Risk formula—in particular, the ILM element—amplifies weaknesses in the formula when ILM is floored at 1.0. We have summarized below recommendations to resolve each of these issues in any final rulemaking. In some cases, we have provided alternative recommendations, recognizing that the Agencies might choose to take one of several approaches that results in generally comparable outcomes.

1. Rescale Operational Risk RWAs to align with a banking organization's highest recent year of operational losses

Banking organizations face operational risks that require capitalization. Similar to credit risk and market risk, operational risk manifests in actual operational losses, which can be measured. We

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[23] Board, "Supervision and Regulation Report," Nov. 2023, p. 22 (here) (citing "operational resilience, including cybersecurity" as among "large financial institutions' supervisory priorities for the coming months").
[24] Deloitte, "Cybersecurity Insights 2023: Budgets and benchmarks for financial services institutions" (here), p. 2.
[25] Deloitte, "Reshaping the cybersecurity landscape" (here), p. 5.
[26] See, e.g., EY, "Cybersecurity is number one risk for global banks, but geopolitical risk tops European banks' concerns," Jan. 11, 2023 (here) ("[T]hree out of four CROs [in EY's 88-bank global survey] identified cybersecurity risk as their top concern over the next 12 months (72%), edging out credit risk (59%).").
[27] 12 C.F.R. § 217.10(b)(4).
[28] 12 C.F.R. § 217.10(c)(2).
[29] 12 C.F.R. Part 217, Subpart H. The G-SIB Surcharge framework combines total leverage exposure with other measures of a bank holding company's size and scale, such as assets under custody and the notional amount of over-the-counter ("**OTC**") derivatives.

recommend that the Agencies utilize actual operational loss data to calibrate any final Operational Risk RWA standard for large U.S. banking organizations.

Specifically, we recommend that any final Operational Risk RWA standard result in capital requirements that are generally aligned with the highest year of operational losses experienced by any banking organization. This could be achieved by identifying the highest year of a banking organization's operational losses in the recent past and multiplying that loss amount by 12.5 to achieve an RWA value for that organization.[30] For example, a banking organization with peak annual operational losses of $1 billion should have Operational Risk RWAs of approximately $12.5 billion.

We appreciate that this calculation would be simplistic and backward-looking—it would not capture, for example, changes in business models that may lead to significant future increases or decreases in operational risk losses. However, it could serve as a helpful benchmark for assessing the overall calibration of Operational Risk RWAs. Operational Risk RWAs that are many multiples of the simplistic, backward-looking calculation suggested here would indicate that Basel Committee-prescribed standards are not well-calibrated (particularly when combined with operational loss projections resulting from application of the SCB to overall RWAs).

We believe that the Agencies should calibrate Operational Risk RWA standards such that resulting RWAs generally align with a banking organization's highest recent year of operational losses. In practice, we recognize that the Agencies might choose to implement a tailored version of Basel Committee-prescribed standards. If the Agencies take this tailoring approach, we recommend that they consider adjustments that would achieve RWA outcomes generally in-line with the historic loss approach.

2. Modify the services component to reflect the modest loss history of certain services businesses and their expense structures

The Operational Risk framework involves inherent complexity, as it is designed to apply a standardized metric to a wide range of diverse business models with variable degrees of operational risk. Conceptually, we believe there are several potential approaches for resolving the concerns we have identified with the services component. In each case, we have offered principles-based recommendations for how the Agencies might adapt the framework for U.S. implementation, but we recognize that some technical calibrations may require further study or data analytics. In addition, while the recommendations are summarized here as distinct approaches, in practice they could be blended together and, per our comments in the preceding section, should be validated against average annual operational losses to confirm the calibration of final standards.

i. Firm-specific PBT margins as a percentage haircut to the services component

As noted in Section B of this Appendix 2, the interest, lease, and dividend component and the financial component of the Operational Risk framework each include "netting" mechanisms in which the

[30] The 12.5 multiplier is a widely used mechanic in the Basel Accord to achieve RWAs calibrated to an 8 percent capital requirement.

Business Indicator incorporates income less expenses. Notably, the Basel Committee considered whether to apply gross calculations in these mechanisms before adopting net standards. For example, the Basel Committee explained that it "explored the possibility of using the sum of interest income and interest expense as a measure of operational risk exposure," but it decided against this approach since "it was observed that changes in interest rate levels would render this measure highly cyclical when such changes do not necessarily imply a corresponding change in the operational risk exposure."[31]

An analogous logic may be applicable to the services component. While business activities included in the services component are diverse and variable, in many cases they involve revenues generated against a fairly stable or predictable expense structure. In certain situations, the same amount of revenues and expenses are recognized due to the applicable accounting standard requirements (sometimes referred to as "revenue gross-up"). Such revenue gross-ups apply when, under U.S. GAAP, payments received by a banking organization correspond to related expenses but the payments received must be reported as revenue for accounting purposes. This is an accounting convention; the banking organization has not received economic value that corresponds to the revenue gross-up, since it passes a portion of the revenue along to a third party. In these cases, relying on gross revenues results in a financial measurement that is incomparable to the "net" calculations utilized by the interest, lease, and dividend component and financial component of the Business Indicator.

For example:

- In client clearing businesses the banking organization receives revenues from its clients that it uses, in turn, to meet clearing or exchange fees associated with facilitating clearinghouse access. U.S. GAAP requires these revenues to be reported gross even when they are reimbursed by clients on a dollar-for-dollar basis.

- In client trading facilitation businesses, exchange fees, clearing fees, regulatory filing fees and foreign country transaction taxes incurred related to stock, bond or derivative trading are reimbursed by clients. As in the prior example, U.S. GAAP requires gross reporting of revenues and expenses in these cases.

- In investment banking businesses, certain advisory expenses and underwriting costs such as travel and legal fees incurred by the banking organization are reimbursed by clients. Again, under U.S. GAAP, these items are reported gross as revenue and expense.

- In investment management businesses, the banking organization receives commissions, Rule 12b-1 fees, placement fees, or trailer fees from investment funds that it uses, in turn, to meet distribution fees and selling expenses paid to brokers and dealers. These amounts are reported gross as revenue and expense for U.S. GAAP.

U.S. GAAP involves technical accounting standards focused on who controls the service; these standards were not designed to serve as an indication of risk for regulatory capital purposes. In the

[31] 2014 Ops Risk Consultation, ¶ 18.

examples above, U.S. GAAP accounting-based revenue reporting would lead to Operational Risk capital requirements, even in cases where the revenues are fully offset by a directly related expense. These types of activities could be viewed as analogous to net interest income activities—which are subject to a net calculation in the proposed Operational Risk formula—since the banking organization is acting as an intermediary.

Similar analysis applies to wealth management business lines that rely on the professional advice of financial advisors. The financial advisors are compensated based on a standard formula, or "grid," that incorporates defined economic variables associated with their clients' portfolios. While the banking organization earns income from the business line, the compensation of the financial advisors is a structural expense in these businesses that is both calculable and predictable. Moreover, similar to the Basel Committee analysis quoted above addressing interest income, a "net" calculation of wealth management income would recognize the fact that income and expenses generally rise and fall together, and so a focus on income in isolation results in an outsized measure of operational risk.

The challenge, however, is that traditional netting methodologies may not be suitable for most business activities included in the services component. While there are some instances in which specific "expense" items can be identified as offsets to income (as in client clearing), in most cases there is a broader structure of expenses that support an overall franchise's capacity to earn fee and commission income. Accordingly, it may be more suitable to use an overarching metric of profitability to achieve a netting-style calibration for the services component.

One potential solution to this problem would be to modify the services component to include an adjustment for firm-specific profit margins. Under this approach, revenues included in the services component would be multiplied by a PBT ratio before inclusion in the Business Indicator. For example, a banking organization with a 50 percent PBT ratio would include half of its gross services revenue in its Business Indicator. We believe there are four reasons supporting this approach.

First, multiplying services revenues by PBT would functionally achieve a "net" calculation similar to the other two components of the Business Indicator. As explained in this Appendix, every dollar of services revenue does not present the same degree of operational risk; in many cases, services revenues are utilized by a banking organization to meet related expenses. While a PBT modification is an admittedly blunt approach, its application to the services component would result in a more consistent design of the three components of the Business Indicator.

Second, a PBT-based approach could be applied to any services-intensive banking organization business model without further tailoring required. One of the practical challenges in applying the services component is the diverse range of business models—and associated operational risks—that are included in its scope. Revenues and related operational risks arising in credit card, custody, asset management, wealth management and underwriting business models are distinct, with variable expense recognition principles applying in each case. A PBT-based approach could be applied consistently and with similar effect across all of these business models and achieve the functional equivalent of a "net" calculation in each case.

Third, a PBT-based approach would be simple to implement. While PBT is not a traditional regulatory reporting metric, it is widely used in securities filings and involves well-understood measurement principles. The Agencies could incorporate a PBT measure into the services component by cross-referencing existing industry definitions or making small adjustment to regulatory definitions and reporting forms.

Fourth, and most importantly, a PBT-based approach appears to be well-designed to achieve the policy objectives of the Operational Risk RWA framework. This Appendix has summarized the various challenges of proposed Operational Risk RWA standards, which originated nearly a decade ago in the Basel Committee process and which raise serious and unique concerns for the U.S. banking industry. The services component is quantitatively over-calibrated and grounded in a pre-2017 time series of data that is not representative of operational loss evidence from more recent years. A PBT-based approach provides a simple mechanism to solve for these issues.

We acknowledge that there could be circumstances in which a banking organization may have a negative PBT ratio in a given year. Incorporating a PBT ratio into a regulatory formula in these cases could lead to unintended RWA outcomes. This problem could be solved, however, by incorporating a three-year averaging mechanism to correct for a one-off PBT ratio outlier.

ii. Variable weightings to services component business lines reflecting their specific loss histories

The risk sensitivity of the Operational Risk calculation might also be improved if the services component weighted income (and expenses) by business line based on an analysis of the relative operational risk profiles of different business activities. This approach has an intuitive logical appeal. Not every dollar of income (or expense) poses the same operational risk; revenues from business lines with demonstrably lower operational risk histories should be included in the calculation at a lower calibration and receive lower Operational Risk RWAs.

The ORX Report may be instructive in calibrating business line-specific adjustments by comparing operational risk losses to revenues. In practice, this might be achieved by introducing a business line-specific variable in the services component formula to achieve different "weightings" that reflect historic operational loss evidence.[32]

iii. Cap services at 25 percent of the BIC

As noted above, the Basel Committee considered a capping mechanism in its 2016 consultation to solve for the acknowledged frictions raised by the proposed services component. As proposed, the Operational Risk formula would have fully recognized service component income (or expenses) until they contributed 50 percent of the banking organization's overall Business Indicator, with additional income (or expenses) above 50 percent recognized at a 10 percent rate. This approach would have, in effect,

[32] Comments submitted by the American Bankers Association and Bank Policy Institute include a more detailed explanation of this recommendation, including how loss evidence from the ORX Report could be incorporated into a formula variable.

capped the contribution of the services component at roughly half as a driver of overall Operational Risk RWAs.

It is unclear why the Basel Committee did not ultimately adopt this proposed mechanic. However, the logic for adopting a capping mechanism is stronger for the United States than in other jurisdictions, given the significant role of fee- and commission-based business lines at U.S. banking organizations and the safety and soundness benefits they offer as stabilizing revenue sources. Accordingly, we encourage the Agencies to consider adoption of a capping mechanism similar in spirit to what the Basel Committee proposed in 2016.

A potential advantage of this approach is its relative simplicity. While more granular data and analysis might inform the design and calibration of a cap, the cap itself could be applied through a simple mathematical adjustment. In practice, the "cut off" threshold for the adjustment might need to be lower than the 50 percent threshold proposed by the Basel Committee in 2016, given U.S. banking organizations' high relative concentrations in services-intensive businesses. In addition, the Basel Committee's 2016 consultation would have included net fee income as a floor, which would undermine the utility of this adjustment for U.S. banking organizations with significant fee and commission income where the cost of doing business is not reflected in "fee expense."[33] In other words, while the Basel Committee's 2016 consultation correctly identified the problem, the solution it proposed would be ineffective. While any final calibration should be based on a review of data and analysis, we recommend that the Agencies consider capping the services component at 25 percent of the BIC to address the structural issues identified by Basel Committee for fee- and commission-based business models.

iv. Potential implementation approach – a percentage multiplier based on U.S. supervisory data

The potential approaches summarized above are aimed, in each case, to improve the accuracy and risk-sensitivity of the services component calculation. The first two suggestions—profit margin and business line-specific calibrations—would involve some degree of data analysis to arrive specific calibrations. While these potential approaches appear to be well designed to improve the calibration of the services component, they admittedly introduce some complexity. Simplicity might be advanced if the Agencies instead applied a "haircut" in the form of a percentage multiplier to the Business Indicator services component. Under this approach, $100 of services revenue would not equal $100 of Business Indicator; instead, only $30 or $40 would be included, based on analysis showing that including only 30 percent or 40 percent of services revenues in the Business Indicator would result in Operational Risk RWAs that are generally aligned with operational loss evidence for the business activities.

In spirit, this approach is very similar to the earlier examples, but it utilizes a simple mechanic in the Operational Risk formula to achieve the final step. The 30 percent and 40 percent example cited above is illustrative only but is meant to demonstrate that the level of recalibration should be based on U.S. empirical evidence rather strict adherence to a Basel Committee-prescribed formula.

[33] 2016 Ops Risk Consultation, ¶ 21.

3. Set ILM at 1.0 or, alternatively, recalibrate floating ILM

This Appendix summarizes a range of conceptual and technical challenges with the proposed Operational Risk RWA standards. In response, we have recommended both a blunt approach—calibration based on a banking organization's highest recent year of operational losses—as well as several potential technical solutions that would adjust the Basel Committee-prescribed formula. These solutions would be frustrated at least in part, however, if they are combined with an ILM greater than 1.0. Accordingly, following implementation approaches in other major jurisdictions, we recommend that the Agencies set the ILM at 1.0 or, alternatively, recalibrate floating ILM.

i. Set ILM at 1.0

As explained by the Basel Committee, the ILM is calculated through a formula in which "the Loss Component (LC) is equal to 15 times average annual operational risk losses incurred over the previous 10 years."[34] The ILM is, accordingly, the mechanism through which the fifteen-year capitalization assumption is implemented. As explained above, this fifteen-year assumption is unsupported by analysis or data explaining why it is an appropriate measure of Operational Risk capitalization.

Setting the ILM at a value other than 1.0 could also have effect of reversing deliberate adjustments to the Operational Risk framework adopted by the Agencies to improve its utility in U.S. implementation. As explained above, the BIC serves as the denominator of the ILM calculation. As a result, all else being equal, reductions in the BIC stemming from revisions to the services component would have the effect of increasing ILM because of the smaller BIC included in the ILM denominator. For example, if the Agencies revised the services component to include a PBT adjustment, the resulting change in BIC would flow through the ILM denominator and increase Operational Risk RWAs (e.g., a targeted reduction applied to the services component would be at least partially offset in the RWA formula by the ILM increase). A decision to recalibrate the services component downward, however, should not result in an increase in RWAs. Accordingly, setting the ILM at 1.0 would permit the Agencies to adopt adjustments to revenue-recognition principles, business segment-specific adjustments, or a services component capping mechanism without needing to consider a corresponding adjustment to the ILM denominator.

ii. If ILM floats, it should not be floored, and the 15x loss history multiplier should be rescaled

While our primary recommendation is to set the ILM at 1.0, it would be possible to achieve a generally similar result with a floating ILM if the loss history multiplier is rescaled. This approach involves some degree of complexity, however, since the BIC serves as the denominator of the ILM formula. As explained above, if the services component is adjusted downward in isolation, that change would have the effect of increasing the ILM since the services component is included in the ILM denominator.

[34] Basel Committee, "Minimum capital requirements for operational risk," Dec. 2017, ¶ 9.

Mathematically, this "denominator effect" could be managed for a floating ILM by adjusting the multiplier of average annual total net operational losses in the ILM formula from 15x to somewhere in the range of 5x to 8x. By suggesting this adjustment, we do not intend to suggest that Operational Risk RWAs should be calibrated to meet five to eight years of operational losses—as summarized above, we believe that the scale of Operational Risk RWAs should align with a banking organization's highest recent year of operational losses—but a mathematical adjustment of the formula in this manner could balance a reduced BIC resulting from adjustments to the recognition of services revenues, which would otherwise increase ILM and, therefore, Operational Risk RWAs.

Appendix 3: Market Risk

The B3EG Proposal would introduce new Market Risk RWA standards based on the Basel Committee's FRTB framework. The Agencies estimate that, under these new standards, Market Risk RWAs would increase by approximately 77 percent for U.S. G-SIBs.[1] This significant increase in capital requirements would directly impact large U.S. banking organizations' capacity to support U.S. capital markets, which meet 75 percent of non-financial U.S. corporates' debt financing needs and create a supply of investable products for U.S. citizens to meet their retirement and savings objectives.[2] More broadly, U.S. G-SIBs' trading book businesses support bespoke investment strategies for pensions and insurance companies that are tailored to these institutions' asset-liability management profiles, provide hedging and risk management products for U.S. corporates' global operations, and play a critical role in supporting the overall health and vibrancy of U.S. capital markets.

We support strong trading book capital requirements. Morgan Stanley significantly rescaled its trading book activities following the financial crisis to support a more balanced franchise that can meet client needs at all points in the economic cycle without taking outsized risks. Also in response to the financial crisis, the Agencies adopted significant regulatory changes to reinforce strong trading book risk management, including through the adoption of "Basel 2.5" Market Risk standards in 2012 and, separately, Volcker Rule restrictions. Significantly, the Board supplemented these regulatory reforms by instituting the GMS component of CCAR, which corrects for perceived weaknesses in Basel 2.5 Market Risk standards.

We expect that, if Market Risk RWA standards are adopted as proposed, U.S. G-SIBs' trading book businesses will continue to function. However, end users, investors and other market participants will have diminished access to, and higher pricing for, capital markets products. Large U.S. banking organizations' trading desks are transmission nodes for the overall economy and changes to capital requirements will have second-order effects on markets. While it is easier to "translate" the effect of higher capital requirements for the banking book directly into the cost of loans, the effect on trading book products is similar. A trading desk that provides, for example, long-dated equity derivatives for pensions or foreign exchange hedging for U.S. corporates with global operations will, all else being equal, be forced to respond to higher capital requirements by reducing access or raising costs.

We believe that the health and vibrancy of the U.S. capital markets are core strengths that fuel job creation and promote economic stability. The U.S. implementation of FRTB should aim to preserve U.S. banking organizations' important roles as intermediaries in these markets.

[1] 88 Fed. Reg. at 64,168.
[2] SIFMA 2023 Capital Markets Fact Book ("**Capital Markets Fact Book**"), Jul. 2023 (here), p. 6.

A. Proposed Market Risk RWA standards would negatively impact U.S. capital markets

1. Impacts on end users' hedging and capital raising activities

Changes in regulatory capital standards impact large U.S. banking organizations' ability to facilitate end users' access to capital markets. Impacts can be both direct—e.g., changes to Credit Risk standards may result in banking organizations repricing transactions to achieve a capital return rate—and indirect, such as changes in pricing resulting from more constrained dealer capacity under revised Market Risk standards.

The B3EG Proposal would introduce transformative changes to the Market Risk RWA framework. While impacts to specific end users and categories of products will vary, the projected 77 percent increase in Market Risk RWAs will necessarily result in more limited capacity at large U.S. banking organizations to facilitate end-user transactions at efficient prices.

Illustrative impact areas include:

- FX hedging: U.S. corporates manage foreign exchange ("**FX**") risks in their global operations, such as costs denominated in one set of currencies and revenues denominated in different currencies, leading to earnings volatility and mismatches in global asset-liability management ("**ALM**") that can be addressed through FX hedging with banking organizations.
    - B3EG Proposal impact: FX hedging is a useful starting point for analysis since effects in this market are already evident from other regulatory capital changes in recent years. The Agencies' revised derivatives counterparty credit risk framework, the Standardized Approach for Counterparty Credit Risk, took effect in 2022 and roughly doubled capital requirements for some FX products.[3] As proposed, Expanded RWA standards may amplify these impacts for FX products through application of CVA charges—particularly for uncollateralized positions, which are commonly used by corporate end users—and by restrictions on banking organizations' ability to recognize cross-asset class diversification, which reduces capital capacity to support end users' FX hedging.
- Interest rate hedging: U.S. corporates raise debt in one form (e.g., floating rate notes) and hedge resulting interest rate risks by converting these liabilities into another form (e.g., fixed rate obligations) as part of consolidated ALM through interest rate hedging with banking organizations.
    - B3EG Proposal impact: The B3EG Proposal would impact U.S. corporations' interest rate hedging practices in at least two ways. First, unlike the Standardized Approach, proposed Expanded Approach RWAs would include a CVA RWA component, with

[3] 85 Fed. Reg. 4362 (Jan. 24, 2020).

CVA capital requirements increasing more significantly for the longer dated and uncollateralized hedging positions typically executed by U.S. corporates. Second, FRTB would increase U.S. banking organizations' market risk capital requirements, introducing heightened pressures at portfolio-level trading book capital management. While standard interest rate hedging products may be less impacted by FRTB, U.S. corporates' ability to obtain longer-dated, more tailored products to meet their specific needs will be constrained.

- Secondary market bond market-making: Large banking organizations make markets in U.S. corporates' bonds and support secondary market trading in these instruments. Secondary market trading is a critical component of the multi-trillion dollar U.S. bond market; investors' ability to buy and sell bonds through market-making intermediaries reinforces market confidence, allows for price discovery, provides investors with a reliable supply of fixed income products, and allows corporations to issue debt at competitive rates.

    - B3EG Proposal impact: Large U.S. banking organizations hold significant trading book inventories of corporate bonds that attract Market Risk RWAs. FRTB IMA applies variable capital requirements to these bond inventories, with much larger requirements applied to holdings of smaller and mid-sized U.S. corporates' bonds through application of NMRF charges to traded products with fewer market transaction observations. All else being equal, FRTB will have a more pronounced impact on the market depth and liquidity of smaller and mid-sized U.S. corporates' bonds, impacting their ability to raise capital efficiently.

- Energy market hedges: Power utilities, airlines and other end users rely on energy inputs (natural gas, jet fuel, solar or wind power, etc.) to provide services to customers, including home heating and airline travel. These end users rely on commodity hedging practices with banking organizations to reduce price volatility, ensure a stable supply of energy inputs or demand for outputs, and provide consumers with the most competitive prices possible.

    - B3EG Proposal impact: As proposed, FRTB SA would include natural gas and electricity products in the same "bucket" for Market Risk purposes in recognition of strong correlation evidence for these two categories of products. However, the risk weight applied to this bucket would be relatively high and the correlation relatively low, as each is calibrated to spot market evidence rather than forward contract market evidence, notwithstanding that in practice the vast majority of large U.S. banking organizations' energy market exposure is in forward contract markets. While the technical mechanics are different, similar concerns arise in FRTB IMA calculations as a result of NMRFs applied to energy positions. Higher RWAs for banking organizations' natural gas and electricity positions will impact the availability and pricing of energy market hedges for end users, with ripple effects for consumers' home heating and airline travel costs.

- Pension investments: Pensions have long-dated investment horizons with variable ALM profiles. They may rely on investment strategies with different risk profiles and related hedging objectives over five-, ten- and fifteen-year time horizons, requiring tailored equity and fixed income products from banking organizations.

    - B3EG Proposal impact: NMRFs in FRTB IMA would apply to all "non-modelled" risk factors for trading book positions at large U.S. banking organizations, including long-dated equity derivatives. NMRF charges are more pronounced for tailored products that banking organizations design with pensions to facilitate the latter's bespoke investment and risk management objectives. These FRTB IMA charges are further compounded by new CVA capital requirements, which would also apply to large banking organizations' exposures to pensions and which would be more pronounced for longer-dated tailored products (similar to the impact on U.S. corporates' interest rate hedges).

2. Activity pushed into shadow banking

The capital markets rely on the finite resources of intermediaries to operate efficiently. Large increases in banking organizations' trading book capital requirements will impact the availability and pricing of products for end users. In general, there are three potential results for end users:

- End users will continue to execute capital market transactions, but at higher costs that correspond to higher capital requirements for their large banking organization intermediaries.

- End users will cease to hedge certain risks where the cost of hedging exceeds the perceived risk management value.

- End users will rely increasingly on unregulated intermediaries to facilitate capital markets access.

This third possibility is, to some extent, an anticipated effect of the B3EG Proposal. Recent evidence indicates that nonbank intermediaries are already playing an increasing role in the provision of credit in the U.S. economy, including in capital markets financing arrangements.[4] Research reports have analyzed how this trend would be further accelerated and reinforced by the B3EG Proposal.[5] The B3EG Proposal acknowledges "the financial stability implications of potential migration of banking activities to nonbanks" but does not analyze or quantify these implications in detail."[6]

[4] See, e.g., The Wall Street Journal, "The New Kings of Wall Street Aren't Banks. Private Funds Fuel Corporate America." Oct. 8, 2023 (here) ("Hedge funds, private-equity funds and other alternative-investment firms have been siphoning away money and talent from banks since a regulatory crackdown after the 2008-09 financial crisis.").
[5] See, e.g., Morgan Stanley Research & Oliver Wyman, "Into the Great Unknown," Nov. 19. 2023 (here), p. 60 ("Asset Managers are poised to capture share with private credit strategies as the proposed new bank capital rule (Basel 3 Endgame) could pressure banks' ability and willingness to hold risk.").
[6] 88 Fed. Reg. at 64,169.

Healthy, competitive capital markets require deep and active engagement from both nonbanks and banking organizations. Competition improves the availability of credit and hedging products as well as the prices at which they are executed. Large U.S. banking organizations, however, act as pillars in these markets, providing through-the-cycle support and full-service franchises able to meet U.S. corporates' global needs across asset classes and time horizons. An outcome in which capital markets activities migrate at an increasing rate out of the regulated banking sector in response to higher capital requirements would not promote overall financial system safety and stability.[7]

B. The Board should revisit GMS calibrations to harmonize them with FRTB

The Board did not reopen its CCAR policy statements for comment when issuing the B3EG Proposal. We believe that there is a demonstrable connection between Market Risk RWA standards and the GMS component of CCAR, and that the Board should consider adjustments to FRTB, GMS or both to reflect this interplay.

The financial crisis revealed fundamental weaknesses in large U.S. banking organizations' trading book capital management. In response, the Agencies adopted, in 2012, the Basel 2.5 trading book capital standards.[8] These new Market Risk RWA standards, which incorporated financial crisis-era market evidence, introduced a new stress test feature that was designed to "take into account concentration risk, illiquidity under stressed market conditions, and other risks arising from the bank's trading activities that may not be captured adequately in the bank's internal models."[9]

The regulatory community understood that Basel 2.5 standards still had limitations that required further work. As explained by the Basel Committee when adopting FRTB:

> The Basel 2.5 framework assumed that individual banks would be able to exit or hedge their trading book exposures over a 10-day period without affecting market prices. However, in times of stress, the market is likely to become illiquid rapidly when the banking system as a whole holds similar exposures. This happened at the height of the crisis as banks were unable to exit or hedge positions in a short time frame, resulting in substantial mark-to-market losses.[10]

The Basel Committee's critique of Basel 2.5 also cited over-generous recognition of diversification as a problem. "The Basel 2.5 internal models approach had no constraint in recognising hedging and diversification benefits across different asset classes (e.g., equities and FX) based on estimates of correlations derived from pre-crisis historical data," the Basel Committee explained. "In the crisis, the diversification effects that were based on historical data disappeared."[11] In other words, the Basel

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[7] See, e.g., Board, "Statement by Chair Jerome H. Powell," Jul. 27, 2023 (here) ("[T]he proposed very large increase in risk-weighted assets for market risk overall requires us to assess the risk that large U.S. banks could reduce their activities in this area, threatening a decline in liquidity in critical markets and a movement of some of these activities into the shadow banking sector.").
[8] 77 Fed. Reg. 53,060 (Aug. 30, 2012).
[9] 77 Fed. Reg. at 53,068.
[10] Basel Committee, "Explanatory note on the minimum capital requirements for market risk" (here) ("**FRTB Explanatory Note**"), Jan. 2019, p. 3.
[11] FRTB Explanatory Note, p. 4.

Committee identified a need for trading book capital standards to include longer liquidity horizons, greater capture of tail risks, and reduced recognition of diversification.

The Agencies' Basel 2.5 market risk standards took effect in 2013.[12] That same year, the Board adopted a policy statement for supervisory stress testing, including for the design and calibration of GMS.[13] This policy statement noted, when designing GMS scenarios, the Board would consider longer liquidity horizons (e.g., GMS scenarios "will incorporate key elements of market developments during the second half of 2008" and may assume that "market liquidity evaporates"),[14] greater capture of tail risks (e.g., GMS scenarios will use 2008-era calibrations as a baseline because, "during this period, key risk factors in virtually all asset classes experienced extremely large shocks; the collective breadth and intensity of the moves have no parallels in modern financial history")[15] and reduced recognition of diversification (e.g., while GMS scenarios will consider "the historical relationships between variables . . . the movement in particular risk factors may be amplified based on theoretical relationships").[16] The Board intended for supervisory stress testing to complement, rather than replace, RWA-based capital requirements, which GMS accomplished: in substance, the Board instituted GMS scenarios that addressed the identified weaknesses in Basel 2.5.

After the Agencies' Basel 2.5 standards took effect in 2013, the Basel Committee continued its work on addressing the perceived weaknesses in global Market Risk standards. These efforts culminated the Basel Committee's adoption, in 2019, of the FRTB framework. The Basel Committee explained that FRTB solved for identified weaknesses in Basel 2.5, in particular through longer liquidity horizons (e.g., in FRTB IMA, "to recognise the risk of market illiquidity, the ES measure prescribes different liquidity horizons for different risk factors"),[17] greater capture of tail risks (e.g., in FRTB IMA, "ES captures the tail risks that are not accounted for in the existing VaR measures"),[18] and reduced recognition of diversification (e.g., in FRTB IMA, "the revised internal models approach limits the amount of diversification benefit assumed in determining capital requirements").[19]

We do not mean to suggest that FRTB is a direct, across-the-board double-count with GMS. The trading desk impacts of FRTB and GMS are variable. However, trading desks in certain asset classes—including credit products and securitizations—face significant RWA increases from FRTB and also recognize consistent annual losses from GMS. In response to these cases and related frictions, we believe that the Board should reopen for comment the 2013 Scenario Design Policy Statement to ensure that the Market Risk RWA standards and GMS scenario design assumptions continue to be complementary. If the Board elects not to reopen this policy statement for consideration, we recommend that it address the

[12] 77 Fed. Reg. at 53,060.
[13] 78 Fed. Reg. 71,435 (Nov. 29, 2013) (adopting the Policy Statement on the Scenario Design Framework for Stress Testing ("**2013 Scenario Design Policy Statement**")).
[14] 2013 Scenario Design Policy Statement, Section 5.2.3(a), (d).
[15] 2013 Scenario Design Policy Statement, Section 5.2.3(b).
[16] 2013 Scenario Design Policy Statement, Section 5.2.3(d).
[17] FRTB Explanatory Note, p. 7.
[18] FRTB Explanatory Note, p. 6.
[19] FRTB Explanatory Note, p. 7.

GMS-FRTB interplay through one of the approaches that we recommended in Appendix 1 to this comment letter.

C. Market Risk standards should give greater recognition to observed diversification offsets across trading desks

FRTB is designed to limit diversification recognition across trading desks. This limitation is more severe in FRTB SA than in FRTB IMA. While limited diversification recognition has the virtue of reducing reliance on historic correlation evidence (a stated objective of FRTB), it may give rise to three problems.

First, if calibrated too severely, restrictions on diversification recognition will lead to inaccurate measures of Market Risk exposure. This is our most fundamental concern. While FRTB SA should prevent over-recognition of diversification—inter-asset class correlations, while meaningful, are also imperfect—it should also incorporate diversification that supports reasoned, evidence-based risk management. In this case, risk managers may reasonably conclude that correlations across asset classes and trading desks support risk management judgments that do not align with RWA-based allocations of capital.

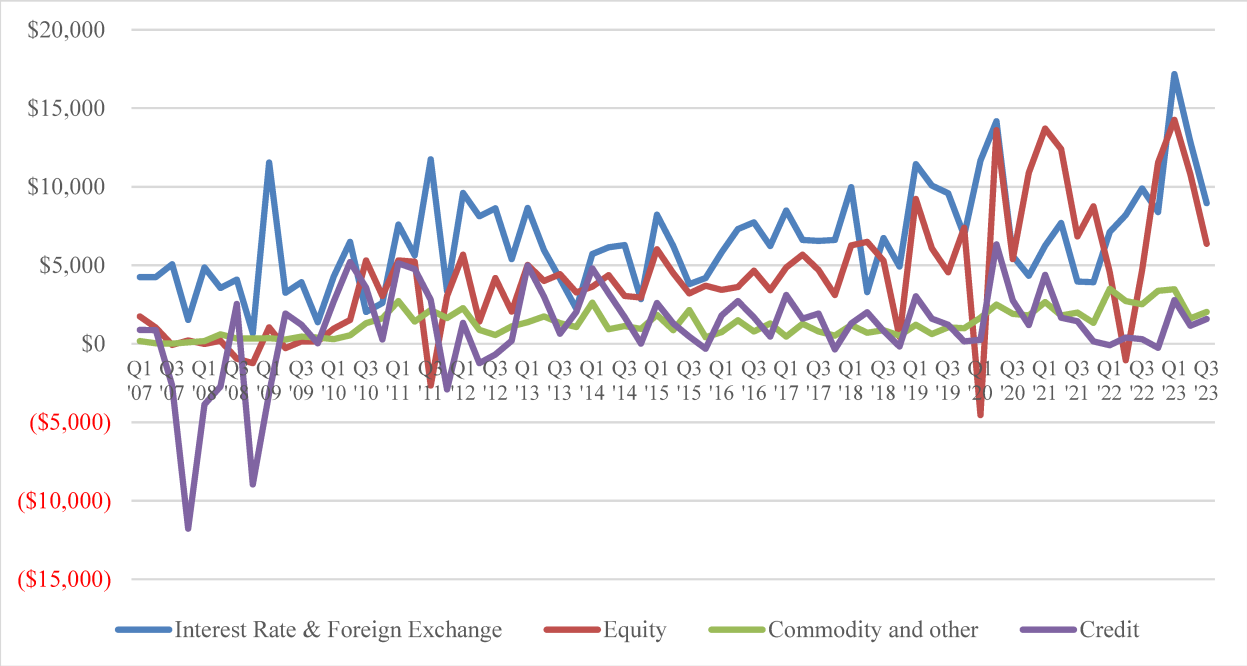
Second, restrictions on diversification recognition create firm-level incentives to pursue monoline or otherwise specialized trading businesses that do not appear consistent with macroprudential safety and soundness objectives. A firm trading only rates products will likely not face significant RWA increases under FRTB, but a firm with diversified trading desks will experience significant RWA increases through the loss of cross-desk diversification recognition. We believe that the banking system is healthier and more stable when large firms have balanced operations, as periodic weaknesses in one area related to economic cycles can be offset by strengths in others that thrive in the same period. Morgan Stanley's post-crisis experience validates this observation.

The benefits of diversified trading franchises appear to be validated by publicly available data in the OCC's quarterly reports on bank trading and derivatives activities.[20] We have summarized in the charts below multiyear data showing the contribution of each asset class to large U.S. holding companies' trading revenues. The evidence shows considerable variability quarter-by-quarter; all else being equal, a banking organization with trading operations in a single asset class would experience greater volatility in revenues than one with diversified operations.

The first chart summarizes data from Q1 2007 through Q3 2023. Using publicly available trading revenue data for all large U.S. holding companies, this chart demonstrates that in periods of weak or negative revenues in a particular asset class (e.g., the 2007-08 period for credit) comparatively strong performance in another asset class (e.g., the 2007-08 period for interest rate and foreign exchange) can provide stabilizing ballast for the banking system. All else being equal, the banking system—and individual banking organizations—are stronger with diversified revenues across asset classes.

[20] OCC, "Quarterly Report on Bank Trading and Derivatives Activities" ("OCC Trading Reports") (here).

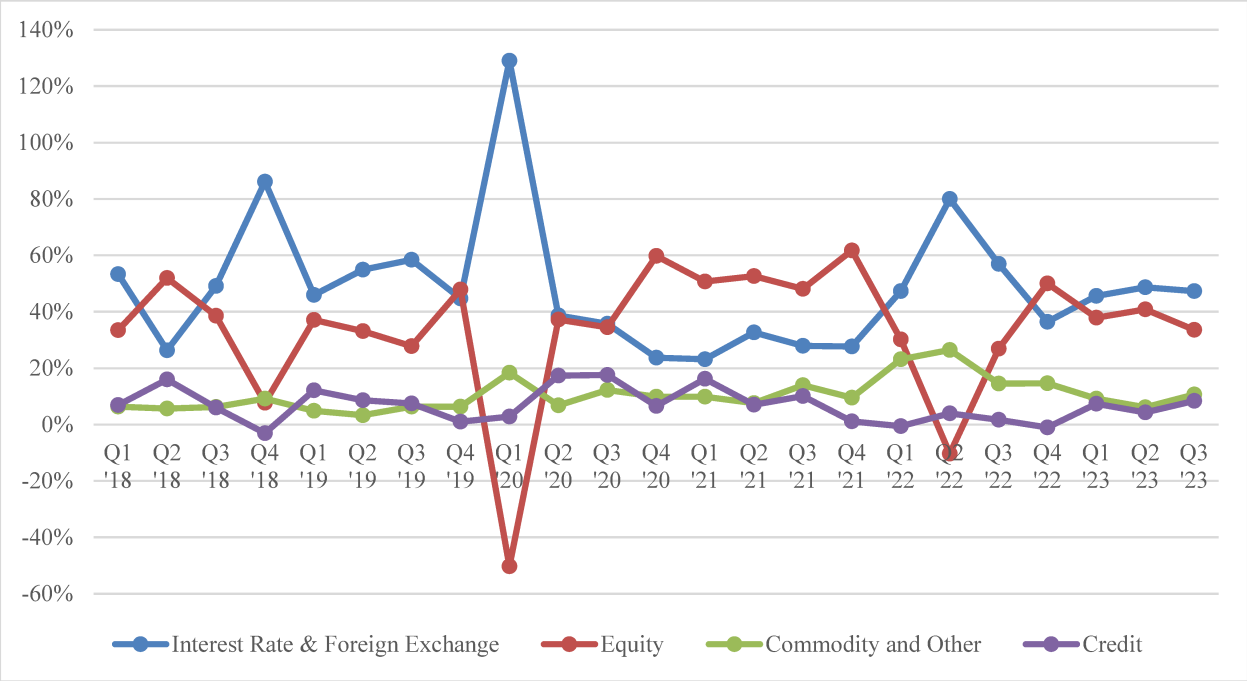
Chart: U.S. BHCs' Trading Activities Revenue by Asset Class (USD MM) (Q1'07 – Q3'23)[21]



The second chart summarizes publicly available data for large U.S. holding companies on a percentage, rather than absolute dollar, basis. Specifically, for each quarter, the chart below summarizes the percentage contribution to revenues from each asset class. Accordingly, the percentages for the four asset classes will sum in each quarter to 100 percent. This chart shows that, while the dollar values of revenues will fluctuate across quarters (as highlighted by the first chart), the relative contribution of each asset class to total trading revenues will also vary, with clear patterns showing offsets across asset classes. Again, all else being equal, the banking system—and individual banking organizations—are stronger with diversified revenues across asset classes.

[21] Morgan Stanley analysis of data in OCC Trading Reports. Data available in OCC Trading Reports is bank-level only through Q1 2010; holding company-level data begins in Q2 2010.

Chart: U.S. BHCs' Trading Activities Revenue by Asset Class (Percentage) (Q1'18 – Q3'23)[22]



Third, restrictions on diversification recognition reduce incentives for individual trading desks to maintain well-balanced portfolios across asset classes that provide meaningful risk management benefits but do not qualify for hedge recognition under FRTB standards. A corporate credit trading desk, for example, may buy equity put options as a hedge. While there is not perfect day-to-day correlation between corporate credit moves and the performance of equity options, the correlation typically holds in volatile markets, providing reliable (but not perfect) hedging benefit in a tail scenario, particularly when a desk is long one exposure (e.g., corporate credit) and short the other (e.g., by buying equity put options). Hedges such as this come at an economic cost to the trading desk, for instance the premium a desk would have to spend in buying an equity put option. A focus on meeting an RWA-based capital return target will, all else being equal, incentivize a trading desk to avoid the cost of generally effective hedging strategies that receive no hedge recognition for RWA purposes, particularly in an operating environment in which RWA increases drive higher RWA-based capital return targets.

D. Greater certainty for IMA is needed to facilitate orderly planning and investments

While large U.S. banking organizations must implement FRTB SA, a decision to pursue FRTB IMA is optional and at each individual banking organization's discretion on a desk-by-desk basis. As a theoretical matter, a model-based approach like FRTB IMA should have a number of benefits, including more accurate risk management and better alignment of risk management and capital outcomes. However, as proposed, FRTB IMA does not appear to provide a meaningful capital benefit, is expensive to

[22] Morgan Stanley analysis of data in OCC Trading Reports.

implement, does not sufficiently recognize legitimate risk management actions, and introduces potential volatility in capital requirements.

We believe modifications to FRTB IMA are needed to address these issues and facilitate significant industry adoption. Our understanding is that a number of large U.S. banking organizations have deprioritized their FRTB IMA programs to focus primarily or only on FRTB SA, at least for the initial effective date. In general, we believe that a reduced or postponed focus on FRTB IMA implementation may be driven by several factors, including:

- Uncertainty about which trading desks would ultimately be able to operate permanently under FRTB IMA by consistently passing the PLAT, given that PLAT metrics have not been calibrated based on U.S. market evidence (and would likely benefit from validation against real-world performance data).

- Pro forma results showing that the ES component—the only "modeled" component of FRTB IMA—drives only a fraction of the overall RWA calculation, leading to concerns about whether FRTB IMA sufficiently incorporates model-based evidence.

- Related to the prior point, the overall dominance of the NMRF component of the FRTB IMA calculation, which effectively makes FRTB IMA a predominantly standardized, rather than model-based, calculation with RWA outcomes that are broadly similar to FRTB SA pro forma RWA estimates.

- The high resource cost—including of technology and human capital—to build an FRTB IMA implementation program at an incremental cost to mandatory and expensive FRTB SA implementation programs.

- Uncertainty about the exact timing of the FRTB IMA application process as well as data submission expectations to support such applications.

- A concern with "springing" capital requirements if a trading desk expects to operate under FRTB IMA but, in the future, is unexpectedly forced to switch to higher FRTB SA requirements.

We appreciate that the risk of "springing" capital is an inherent design feature of FRTB, since the Basel Committee expressly sought to design FRTB SA to be a credible alternative to model-based Market Risk calculations. Accordingly, we do not believe that "springing" capital risk can (or should be) eliminated entirely from the framework, since doing so would weaken incentives to maintain robust FRTB IMA processes built against objective criteria. Our concern, however, is focused on the uncertainty of FRTB IMA performance post-implementation, in part for the reasons summarized above. We believe there are strong potential benefits of providing banking organizations with reasonable accommodations to build and maintain successful FRTB IMA programs, particularly for the initial post-implementation period, and to smooth changes in capital requirements when they may occur under FRTB, as explained in greater detail below.

The following sections of this Appendix 3 summarize our key technical recommendations for improving FRTB IMA. While the adoption of FRTB IMA by large U.S. banking organizations faces various uncertainties and challenges, we believe that tailored adjustments to the framework would result in broader voluntary adoption and better alignment of trading book capital management and risk management practices. Achieving this outcome might, in practice, involve an immediate focus on the "less contested aspects" of FRTB IMA while more complex issues (including PLAT) are subject to ongoing assessment.[23]

E. FRTB IMA standards should be revised to better align capital management with risk management

1. PLAT recommendation

Our comments in Section D of this Appendix 3 highlighted a range of concerns with FRTB IMA implementation. In practice, these concerns would be addressed to a significant extent by PLAT accommodations designed to facilitate orderly planning of FRTB IMA implementation programs.

Morgan Stanley submitted comments to the Basel Committee during the development of its FRTB standards.[24] We reiterate here our analysis from that letter:

> While FRTB IMA standards represent significant evolution in market risk methodology, substantial uncertainties exist around how the PLA Test will perform in practice, and whether jurisdiction-specific market practices will require adjustments to the test. We believe that an orderly implementation of FRTB should seek to avoid unnecessary disruptions to client service businesses resulting from thresholds that could be more appropriately calibrated and tested against actual trading portfolios as opposed to hypothetical portfolios. PLA testing of actual trading portfolios requires modelling and infrastructure changes that, while underway, will require additional time to implement and evaluate all relevant data.[25]

Our comments concluded by recommending that "the Basel Committee recognize a monitoring period to evaluate the performance of the PLA Test against actual portfolios."[26]

We raise a similar recommendation for the Agencies' consideration in connection with U.S. implementation of FRTB based on the reasons as expressed in our earlier letter. We respectfully encourage the Agencies to consider FRTB IMA implementation standards with these PLAT features:

- All large U.S. banking organizations seeking to qualify trading desks for FRTB IMA would be required to perform PLAT on an ongoing basis as proposed.

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[23] See Jonathan McKernan, "Remarks at ISDA's Conference on Trading Book Capital: Basel III Implementation," Dec. 12, 2023 (here).
[24] Comment letter from Morgan Stanley to the Basel Committee, Jun. 20, 2018 (here) ("**2018 MS FRTB Letter**").
[25] 2018 MS FRTB Letter, pp. 3-4.
[26] 2018 MS FRTB Letter, p. 4.

- Large U.S. banking organizations would be required to submit PLAT results to the relevant Agency as proposed, but failure of a trading desk to meet PLAT metrics would not result in FRTB IMA disqualification.

- Based on their review and analysis of PLAT supervisory data, the Agencies would confirm whether PLAT metrics are appropriately designed for U.S. market conditions. Once confirmed, PLAT metrics would operate permanently as supervisory tools, providing the Agencies with data on the performance of trading desk models across a range of asset classes and economic operating environments.

- Disqualifications of trading desks under FRTB IMA would result solely from back-testing failures.

- Any back-testing-based disqualifications should apply after a one-quarter grace period. During this grace period, a banking organization would be permitted to address underlying issues that caused the back-testing failure.

    - If the banking organization can credibly demonstrate that it could remediate underlying model performance issues such that the trading desk would be able to remedy the back-testing issues, the trading desk could remain on FRTB IMA.

    - Alternatively, a banking organization could demonstrate that back-testing failure was caused by extraneous circumstances outside the banking organization's control (such as during the recent pandemic), and the grace period could be extended by the supervisor.

We appreciate that the Agencies may view PLAT as a useful, self-executing standard that avoids the need for discretionary actions by the Agencies to force individual banking organization onto FRTB SA (or permit them to continue operating under FRTB IMA). Under this view, PLAT operates as set of metrics independent of supervisory assessments, creating a common, objective minimum standard.

We understand the logic of this view but would note in response that it appears premised on a starting point that the proposed PLAT metrics are well-designed to distinguish between high-performing and under-performing FRTB IMA trading desks. The B3EG Proposal does not include analysis to justify this starting point assumption, however, and concerns have been raised that PLAT metrics may penalize well-hedged trading desks.[27] The collection of PLAT supervisory data would permit the Agencies to confirm whether PLAT metrics are actually well-designed to achieve their stated aim or if further refinements are justified.

U.S. banking organizations may also be more willing to invest in FRTB IMA implementation programs if they had assurances that PLAT would not be a "hard" requirement and would, instead, be considered by supervisors as one part of a holistic assessment of model performance. Broader adoption of

[27] See Greg Hopper, "The New Profit and Loss Attribution Tests: Not Ready for Prime Time," Dec. 14, 2023 (here) (providing examples of how, under proposed PLAT metrics, "*the more effectively a bank hedges its market risks, the more the tests will tend to fail")* (italics in original).

FRTB IMA would, we expect, have tangible benefits for risk management across institutions by reducing singular reliance on FRTB SA. A diversity of approaches across FRTB IMA and FRTB SA would provide valuable risk management insights and help identify weaknesses or miscalibrations in either FRTB IMA and FRTB SA that require correction.

i. PLAT – Thresholds calibration Initial IMA Application – Model Eligibility

As explained above, we do not believe that PLAT should be applied as a "hard" requirement for trading desks operating under FRTB IMA. If, however, PLAT is applied in some form, we believe that the p-value should be clarified for circumstances in which less than 12 months of data is used.

Under the B3EG Proposal, initial IMA application is allowed based on less than 12 months' worth of back-testing data and PLAT results. The B3EG Proposal, however, specifies a pro-rated approach in the context of back-testing but without specific back-testing data thresholds.[28] We therefore suggest that the B3EG Proposal be clarified to use the p-value to revise applicable thresholds for both back-testing and PLAT, when less than 12 months of data is used, for the initial IMA application.

2. Non-Modellable Risk Factors recommendations

Our major structural concern with FRTB IMA is the calibration of NMRFs. Our internal analysis suggests that, as proposed, of the three FRTB IMA components, NMRFs are the largest single driver of FRTB IMA RWAs. We do not believe this analysis is unique to Morgan Stanley, but instead arises from the inclusion of all NMRFs in the SES calculation. Beyond the significant RWA impact, the proportional weight of NMRFs in FRTB IMA raises more fundamental concerns about the dominant role of "non-modelled" elements, including both NMRFs and DRC, in what is supposed to be a model-based calculation. As proposed, the NMRF framework is not risk-sensitive, in contrast to the Agencies' stated objectives for FRTB IMA. We support the proposal of the Joint ISDA-SIFMA Letter (Section II.A) that Type A NMRFs should be capitalized in ES directly, while Type B NMRFs should be capitalized using the SES calculation.

We recommend that the Agencies consider adjustments to the NMRF calculation in any final rulemaking. In our view, this could be achieved by building on an already recognized distinction in the FRTB IMA framework between NMRFs of varying data availability and quality. Both ES and NMRF SES utilize a period of stress from 2007 onwards. In ES, the principal determinant of whether a risk factor should enter this calculation is the existence of robust and appropriate market data time series and/or models for the risk factor. In FRTB IMA, the so-called "data principles" play the important role of making this determination. However, the determination of modellability, on the other hand, is made solely on the last one year of data through the Risk Factor Eligibility Test ("**RFET**"). This approach results in penalizing NMRFs for which bank organizations have robust methods of constructing historical data.

We recommend that banking organizations be permitted to reflect differences in NMRFs' data availability and quality by distinguishing between Type A and Type B NMRFs.

[28] § __.212(b) (proposed).

- Type A: NMRFs for which the banking organization can construct or provide data that pass ES data principles should be solely capitalized by ES. Furthermore, since these risk factors are less liquid than their modellable counterparts, we propose to increase their applicable liquidity horizons by one notch.

- Type B: NMRFs that do not meet the above conditions for classification as Type A should continue to be capitalized through stress scenarios as they are not suitable to be included in the ES framework.

We believe this recommendation is logical, for three reasons. First, it improves risk sensitivity in the FRTB IMA framework by allowing risk factors to be included in ES, the only modelled element in IMA, provided that they pass data principles in the current and historical periods. While we appreciate that the data principles do not constitute an automatic test to distinguish Type A NMRFs, such a feature could be incorporated into any final rulemaking by requiring a minimum number of distinct data points for Type A NMRFs in the current period.

Second, this recommendation reinforces the objective of imposing higher capital requirements for trading book positions with less liquid, non-modellable risk factors. Type A NMRFs, if included in ES, would be subject to more conservative liquidity horizons than modellable risk factors. Imposing longer liquidity horizons on less liquid positions is consistent with the design logic of FRTB IMA and recognizing a Type A-vs.-Type B distinction would improve the risk sensitivity of the framework.

Third, our analysis indicates that the inclusion of Type A NMRFs in ES would correct for some of the more striking end user impacts from FRTB. We demonstrate this via an example with two corporate bonds.

In general, the very largest U.S. corporates' bonds can be expected to attract low or zero NMRFs given the extensive trading market data for these instruments. Mid-sized corporates' bonds, by contrast, will attract comparatively high NMRFs, since trading in mid-sized issuers' bonds generally occurs less frequently. To illustrate these points, we considered FRTB IMA pro forma estimates for a banking organization holding bond inventory from two issuers.

- Issuer 1 is a non-financial U.S. corporate with market capitalization between $150 and $200 billion.

- Issuer 2 is a non-financial U.S. corporate with market capitalization between $8 and $12 billion.

We have anonymized the analysis here by not providing the names of the issuers, but the identity of the issuers is not the key difference. Issuer 1 and Issuer 2 are both investment grade and their bonds have generally similar economic terms. The key factor in the analysis is the difference in the size of the issuers, since higher NMRFs only apply to the smaller issuer's instruments.[29]

[29] This illustration excludes the effect of DRC charges, which we estimate would be comparable for Issuer 1 and Issuer 2.

In the tables below, we summarize pro forma ES and NMRF estimates for these two bonds. The first table summarizes ES and NMRF estimates for the two bonds as calculated under the B3EG Proposal, whereas the second table summarizes ES and NMRF estimates for the two bonds under our recommended approach. We assume, for purposes of this pro forma analysis, that Issuer 2's NMRFs would be considered Type A, consistent with our analytical approach for Type A NMRFs summarized above. We believe that large banking organization have mature specific risk models and a well-developed framework to assess the robustness of such models that would generally result in U.S. corporate bond NMRFs being classified as Type A.

ES/NMRF Example (B3EG Proposal)

Bond Issuer	**Notional**	**ES**	**NMRF**	**Maturity**	**Total ES/NMRF Capital**
Issuer 1	$10,000,000	$424,231	$0	5 Years	$424,231
Issuer 2	$10,000,000	$105,936	$1,216,465	4 Years	$1,249,413

ES/NMRF Example (Type A NMRFs Included in ES)

Bond Issuer	**Notional**	**ES**	**NMRF**	**Maturity**	**Total ES/NMRF Capital**
Issuer 1	$10,000,000	$ 424,231	$0	5 Years	$424,231
Issuer 2	$10,000,000	$ 578,012	$0	4 Years	$578,012

As illustrated by this example, the banking organization's capital requirements would be approximately three times higher when holding the bond inventory from Issuer 2 as compared with Issuer 1. This difference is driven by NMRFs, which contribute more than 90 percent of the combined ES/NMRF charges for the Issuer 2 bond. This large differential arises even though the bond of Issuer 2 has slightly shorter maturity than the bond of Issuer 1.

The second table illustrates the effect of including Type A NMRFs in ES. The resulting capital requirement for holding inventory in the bond of Issuer 2 is still higher than for the bond of Issuer 1, but by approximately 35 percent instead of nearly threefold. To be clear, Issuer 2's bond does present elevated market risk concerns relative to Issuer 1's bond, but that difference can be measured and capitalized against by including Type A NMRFs in ES. The ES calculation for Issuer 2's bond is more than five times greater in the second example as a result of including Type A NMRFs.

This illustration highlights an important public policy consideration for the Agencies. The B3EG Proposal requests comment on how the proposed Credit Risk framework would impact small- and medium-sized entities.[30] These impacts are not limited to banking book loans, however; smaller U.S. corporations also raise financing in the capital markets. A regulatory capital framework that applies add-ons to smaller non-financial corporates' debt instruments merely because they are smaller issuers will logically result in greater impediments and higher costs for them to access capital markets. Permitting Type A NMRFs to be included in ES would improve the utility and risk management value of FRTB IMA and also reinforce smaller corporates' ability to efficiently raise financing.

Our initial internal estimates indicate that 40 to 50 percent of U.S. corporates' bonds would be subject to NMRFs under FRTB IMA. This is an estimated range, and we expect NMRFs would apply to bonds issued by larger corporates when the instruments have bespoke features. However, for market standard bonds, we expect that NMRFs will apply to a greater extent for smaller and mid-sized corporate issuers' bonds than for the largest issuers.

For these reasons, we recommend that any final rulemaking permit banking organizations to include Type A NMRFs—but not Type B NMRFs—in the ES calculation. As explained above, Type A NMRFs would be included in ES at a liquidity horizon that is one notch higher than the corresponding one for modellable risk factors in the B3EG Proposal to achieve conservatism.[31]

i. Related NMRF Issues

We support the position of the Joint ISDA-SIFMA Letter (Section II.C) that a banking organization should be permitted to calculate NMRF capital requirements at the risk-bucket level with supervisory approval. This approach would be consistent with the Basel framework and would be more appropriately risk sensitive because it would take into account the benefits of netting and correlations with respect to NMRFs within the same risk bucket. The proposed SES formula would not permit a banking organization to construct NMRF shocks at the level of the particular risk bucket.[32]

We also support the position of the Joint ISDA-SIFMA Letter (Section II.H) that the SES stress window be aligned with the stress window used for purposes of the ES calculation. Under the B3EG Proposal, a banking organization would be required to calculate a capital measure for each NMRF using a stress scenario that is calibrated to be at least as prudent as the ES-based measure used for modellable risk factors and must select a common 12-month period of stress for all NMRFs in the same risk factor class.[33] If the banking organization cannot determine a stress scenario for a risk factor class or a smaller set of

[30] 88 Fed. Reg. at 64,054 (Question 40).
[31] This technical recommendation could be adopted in Section 215(c)(1) of the B3EG Proposal. For the Agencies' consideration, this illustrative regulatory text language may be suitable for this purpose: "For all model-eligible trading desks, a [BANKING ORGANIZATION] must include all modellable risk factors in its internal models used to calculate the aggregate liquidity horizon-adjusted ES-based measure. In addition, a [BANKING ORGANIZATION] may include non-modellable risk factors in its internal models used to calculate the aggregate liquidity horizon-adjusted ES-based measure, as long as the supporting data pass the ES data principles. Such non-modellable risk factors must be allocated a liquidity horizon that is one level higher than the corresponding one from §__.215, Table 2, and may be removed from the SES calculation specified in §__.215(d)(2)."
[32] § __.215(d) (proposed).
[33] §__.215(d)(1)(i) (proposed).

NMRFs acceptable to the relevant Agency, the banking organization would be required to use the scenario producing the maximum possible loss as the stress scenario.[34]

A banking organization should be permitted to use the same stress period for NMRFs as is used for purposes of the ES calculation because the ES stress period represents an appropriate period to reflect market stress for a banking organization. It is operationally burdensome for a banking organization to select and maintain separate stress periods for each NMRF risk class. Selecting different stress periods results in additional breakdown of correlations between NMRF risk classes beyond the conservative aggregation formula.

3. FRTB IMA diversification

This Appendix has summarized evidence that diversified businesses are more versatile throughout economic cycles. While our concerns with limited diversification recognition are primarily focused on FRTB SA, we also recommend increased diversification recognition in FRTB IMA. Accordingly, we support the position of the Joint ISDA-SIFMA Letter (Section II.E) in recommending that rho parameter used in ES for modellable risk factors be set at 0.75 instead of 0.5, and the position of the joint ISDA-SIFMA Letter (Section II.B) in recommending that the rho parameter used in SES for NMRFs be set at 0.25.

F. Other FRTB IMA technical recommendations

FRTB IMA requires a complex implementation program. A certain degree of complexity is inherent and necessary when building and operating FRTB IMA, given the complexity of markets and calculation systems involved. However, in other areas refinements could be made to reduce unnecessary complexity, improve versatility throughout the economic cycle, and reduce operating costs. Our FRTB IMA technical recommendations are framed by these considerations.

Some of our recommendations below address PLAT design and calibration issues. We have included these technical recommendations for consideration in the event that PLAT is applied as a "hard" requirement in any final rulemaking.

1. ETFs and investment trusts

As a condition for inclusion in internal models, the B3EG Proposal requires that equity investment in funds be modelled either by using the look-through approach or requesting approval for alternative modelling approaches.[35] We believe that the look-through requirement in IMA is relevant for assets with potentially limited price discovery in the market, such as mutual funds. For very liquid instruments, such as the securities of exchange traded funds ("**ETFs**"), which do not suffer from price discovery concerns, the limited benefit that the look-through approach offers is not commensurate with the operational burden that this requirement creates.

[34] §__.215(d)(1)(ii) (proposed).
[35] §__.205(f) (proposed).

The principle behind the look-through requirement is that if a banking organization cannot discover the price of an asset reliably in the market, it cannot properly mark it to market. However, if the asset can be decomposed into components with good price discovery, proper mark-to-market pricing is achievable. This idea is reflected in various regulatory texts, including the B3EG Proposal. ETF share prices are highly correlated to the value of the ETF's underlying portfolio of assets. Operationally, it is therefore much easier to use share price data rather than attempting to look to the ETF's underlying assets. The portfolio of assets, by necessity, contains many more data elements, and, moreover, may contain assets whose prices are not easily discovered. The divergence between the timeliness and accessibility of public share prices and underlying portfolio valuations is exacerbated during periods of stress when the ETF price-Net Asset Value (NAV) basis grows, as the market re-prices the ETF very quickly but the re-pricing of the component assets occur with a lag due to liquidity. In such cases, enforcing the look-through mandate would mean that IMA will have to use stale component prices rather than observable ETF market prices. This seems to contradict the regulatory goal of accurate mark-to-market pricing.

We therefore recommend that the Agencies apply the look-through requirement only to mutual funds or other funds without publicly traded securities. In other cases, banking organizations should have the option—but not requirement—to apply look-through treatment.

In addition, we support the position of the Joint ISDA-SIFMA Letter (Section II.L) that banking organizations should be permitted to use alternate modelling approaches with respect to equity investments in investment funds without needing to obtain prior approval. More specifically, we ask the Agencies to permit banking organizations to use price-based modelling as long as periodic monitoring is performed. This approach would permit banking organizations to directly incorporate an ETF's prices rather than the prices of the ETF's constituents, which may change over time or be subject to different weightings within the ETF.

2. HPL/RTPL

We support the position of the Joint ISDA-SIFMA Letter (Section II.S) that there should be flexibility to apply daily valuation adjustments to Hypothetical Profit and Loss ("**HPL**"). Many types of daily valuation adjustments (e.g., bid/offer and independent price verification processes) generally are not modelled in the risk management model and therefore would simply add "noise" to HPL in connection with back-testing and PLAT (if PLAT metrics are applied at all).

The Agencies should revise the B3EG Proposal to provide banking organizations with the flexibility to determine the types of daily valuation adjustments that should be included in HPL. We suggest that the Agencies require that only valuation adjustments that are included in internal risk management models and are updated daily should be included in HPL (for example, liquidity adjustments should not be included). This approach would allow for an "apples-to-apples" comparison between HPL and RTPL/VaR which would ensure that PLAT (if PLAT metrics are applied at all) and back-testing remain true statistical tests of the risk models, as intended by the FRTB IMA framework.

3. HPL – Time effects – Model eligibility

Under the B3EG Proposal, time effects are explicitly excluded from HPL.[36] However, the treatment of time effects is required to be the same treatment in HPL and RTPL. The exclusion of time effects from HPL essentially forces banking organizations to remove time effects from their risk models more generally. We request that the Agencies allow the inclusion of time effects in HPL, since the B3EG Proposal's exclusion is a departure from international standards and banking organizations should retain the flexibility of including time effects in their models.

4. Constrained ES measures

The B3EG Proposal requires daily calculations for the constrained ES capital charge, which we believe will be operationally burden if required at this frequency.[37] The Basel Committee's FRTB standards allow this measure to be computed weekly.[38] Therefore, we suggest that the Agencies clarify that the capital requirement from constrained ES measures may be calculated on a weekly basis, in line with international standards.

5. Constrained ES scalar – frequency updates

Under the Basel framework, a banking organization is allowed to update the scalar used to determine the constrained ES capital requirement on a weekly basis. However, similar flexibility is not provided for the scalar used in the indirect approach to determine the stressed ES measure (defined as the ratio $ES_{F,C}/ES_{R,C}$). Stressed measures under the current Market Risk framework are determined on a weekly basis, as they are not expected to materially change on a daily basis. Therefore, we recommend that the Agencies clarify that this scalar can be updated on a weekly basis.

6. RFET observation window

In line with international standards, the B3EG Proposal allows a maximum of a one-month lag between the real price observations ("**RPO**") observation period and the RFET assessment in order to provide sufficient time to gather and aggregate data from external sources. The B3EG Proposal ties the allowed time lag to the ES current period window.[39] However, unlike the Basel framework, the B3EG Proposal does not specify that this one-month lag is meant to represent the period between the end of the one-year RPO observation window and the RFET assessment. The omission of this important specification may have the unintended potential consequence of more frequent RFET updates than the quarterly frequency stated in the B3EG Proposal. Therefore, we recommend that the Agencies clarify that the one-month gap allowed between the RFET observation period and the ES current period window is only applicable, quarterly, when RFET is performed.

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[36] § __.202(b)(6) (proposed) (" . . . Valuation adjustments for which separate regulatory capital requirements have been otherwise specified, commissions, fees, reserves, net interest income, intraday trading, and time effects must be excluded.").
[37] § __.215(c)(ii)(3) (proposed).
[38] See MAR33.15, FAQ1.
[39] See §__.214(b)(1) (proposed).

7. Risk factors derived from other risk factors

We request that the Agencies clarify that combinations of modellable risk factors are generally expected to be considered modellable. As stated in the preamble to the B3EG Proposal, "the proposal would allow the data used to calibrate the IMCC expected shortfall model to include combinations of other modellable risk factors."[40] This permission is conditional: "a risk factor derived from a combination of modellable risk factors would be modellable only if this risk factor also passes the risk factor eligibility test."[41]

We are concerned the preamble's requirement that risk factors that are derived from a combination of modellable risk factors are still required to be separately assessed for modellability, which deviates from international standards, will be operational burdensome while offering limited benefit in ensuring that only sufficiently liquid risk factors are included in the ES model. Therefore, the Agencies should not include it in the final rule or related guidance.

8. Audit requirements for external data providers

We support the position of the Joint ISDA-SIFMA Letter (Section II.O) with respect to the proposed requirement that third-party data providers be subject to audit regarding the validity of their pricing information.[42] The Agencies should revise the B3EG Proposal so that the third-party audit requirement does not apply to regulated entities, such as swap data repositories subject to the oversight of the Commodity Futures Trading Commission ("**CFTC**") and the Trade Reporting and Compliance Engine subject to the oversight of the Financial Industry Regulatory Authority.

9. Expand the Real Price Observation (RPO) scope to include consensus pricing observations

We are concerned about the restriction in the B3EG Proposal that allowable sources for RPOs for RFET purposes are limited to actual trades and committed quotes. If limited in this manner, a large number of material risk factors may be classified as non-modellable, even when they are, in current practice, accurately modelled based on frequent consensus price data (e.g., using Totem as a market data source). As a result, this restriction would effectively limit the scope of risk factors eligible for inclusion in ES, contributing to the outsized role of NMRFs.

Established market consensus service leaders such as Totem provides the consensus of mid-market prices from active market participants for various products. These services apply rigorous controls processes to ensure the consensus prices are a true reflection of current market conditions and therefore they can be considered as observations of associated risk factors. We recommend that any final rulemaking expand the scope of RPOs to include observations from independent consensus price providers subject to adequate controls requirements to be evidenced by such service providers.

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[40] 88 Fed. Reg. at 64,134; §__.214(b)(1)(i) (proposed).
[41] Id.
[42] See §__.214(b)(3)(ii) (proposed).

G. The Agencies should consider specific adjustments to proposed FRTB SA standards to better reflect market evidence

All large U.S. banking organizations subject to Market Risk capital standards would be required to calculate FRTB SA RWAs for each trading desks, even if they apply for and receive permission to utilize FRTB IMA. As such, FRTB SA is the critical foundation for the entire future Market Risk framework. We have highlighted in this section specific recommendations that, we believe, should be considered in any final rulemaking to improve the calibration and operation of FRTB SA.

1. Diversification recommendation

As proposed, FRTB SA standards would permit limited diversification recognition within each asset class but not across asset classes. We respectfully recommend that the Agencies consider modifying the FRTB SA aggregation formula to permit limited diversification across asset classes, which could be achieved by inserting a new inter-asset correlation parameter (ρ_{bc}) into the FRTB SA formula, as indicated here:

$$capital\ requirement = \sqrt{\sum_b SBM_b^2 \ + \sum_b \sum_{c \neq b} \rho_{bc} SBM_b SBM_c} + DRC + RRAO$$

In this formula:

- SBM_b is equal to the risk class-level capital requirement for each of the asset classes: GIRR, Equity, FX, Commodities and Credit (non-securitization non-CTP, securitization non-CTP and CTP); and

- ρ_{bc} is a new inter-asset correlation parameter (effectively set to 100 percent in the proposed FRTB SA framework.

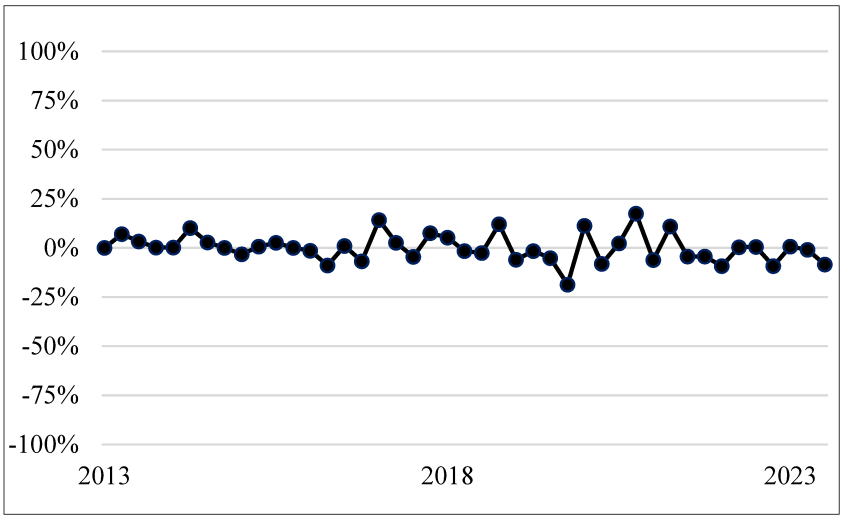
While mathematically ρ_{bc}, the inter-asset correlation parameter, could in theory be set anywhere between -1 and +1, as a practical matter there will be some lower bound depending on the precise mix of risk class-level capital requirements a banking organization holds. Lower values approaching -1 (or -100 percent) represent increasing recognition of inter-asset diversification. By contrast, higher values approaching +1 (or 100 percent) represent decreasing diversification recognition across asset classes. If set at +1, the inter-asset correlation parameter would have no effect, as risks across asset classes would be purely additive (as is the case in proposed FRTB SA standards).

The charts below analyze the empirically observed inter-asset correlation for Morgan Stanley, based on results from the firm's VaR model, the closest publicly available analogue from the current framework to the SBM.

For the first chart below, we sourced asset class and total VaRs from the firm's Pillar 3 disclosures for trading activities over more than a decade and used them to imply a value for ρ_{bc}. As reflected in the chart, while the evidence indicates the ρ_{bc} remains in a fairly tight range, bounded by a high- and low-correlation quarters of 20 percent and -20 percent, respectively, with most readings

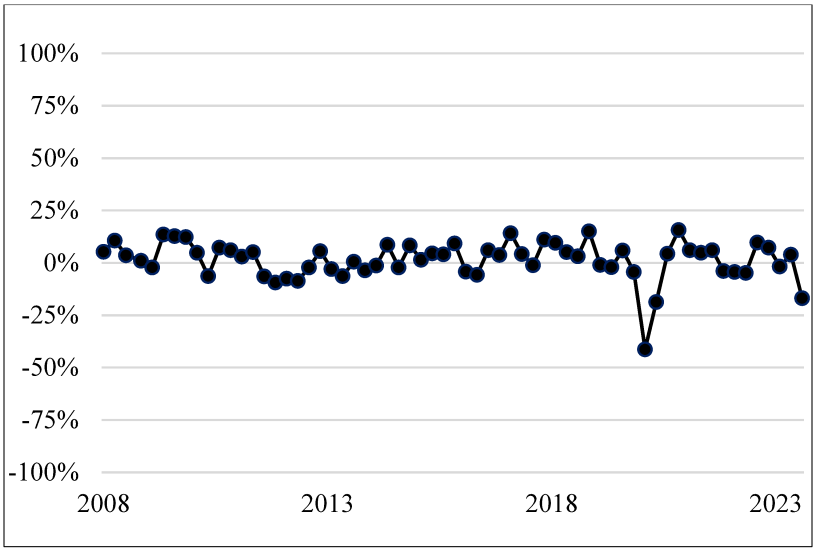
clustered around a 0 percent correlation. Additionally, we do not observe any significant variability over the wide variety of market environments, including the COVID period.

Chart: Trading Activity Correlation Evidence in Morgan Stanley's Pillar 3 disclosures[43]



The second chart involves a similar analysis but uses management VaR evidence included in Morgan Stanley's Form 10-Q securities filings. Securities disclosures provide a longer time series for analysis and consideration but are limited to comparisons of four asset classes (including a combined credit and rates asset class).

Chart: Trading Activity Correlation Evidence in Morgan Stanley's Form 10-Q disclosures[44]



[43] Morgan Stanley's Pillar 3 disclosures are available on the Firm's website (here).
[44] Morgan Stanley's Form 10-Q disclosures are available on the Firm's website (here).

This evidence suggests that a value of ρ_{bc} of 0 through the cycle would be accurate. While a more conservative inter-asset correlation parameter of 20 percent would also be supported by this evidence, outlier outcomes could also be addressed through GMS if the FRTB SA inter-asset correlation parameter were set at 0 percent. An inter-asset correlation parameter of greater than 20 percent could, of course, be assigned to achieve an even higher degree of conservatism, but such a calibration would not be supported by evidence in Morgan Stanley's disclosures.

2. Electricity and natural gas bucket risk weight and correlation

We support the Agencies' grouping gaseous combustibles and electricity within one commodity bucket for purposes of determining the delta risk weights for commodity risk.[45]

Electricity and natural gas markets demonstrate strong correlation, in part because natural gas is most often the fuel of the marginal electricity generation fleet, required to satisfy demand during peak periods. In fact, in 2022 natural gas accounted for 33 percent of the U.S. power sector's primary energy consumption,[46] whereas in Europe natural gas was responsible for only 20 percent.[47] This difference is partly driven by the Europe's higher reliance on renewable sources like wind, hydro, solar and biofuel.

The European and North American energy markets also differ in the availability of domestically produced natural gas. Whereas the United States has ample natural gas production facilities—and indeed is an exporter of natural gas in liquified form—Europe is a net importer, relying on natural gas sourced from countries like Russia.[48] This dynamic, particularly in the current geopolitical context, introduces idiosyncratic volatility to European natural gas prices, and lowers the correlation between European natural gas and power prices as compared with those evident in North American markets.

In addition to the grouping of natural gas and electricity in one commodity bucket, we also endorse the position of the Joint ISDA-SIFMA Letter (Section I.R) that the risk weight and correlation percentage applied to this bucket be calibrated based on forward contract market evidence rather than spot market evidence, with the risk weight for the gaseous combustibles and electricity bucket reduced from 45 percent to 30 percent to more accurately reflect the historical volatility of these arrangements. The B3EG Proposal acknowledges this reality in other areas by requiring that "if the internal risk management model typically values electricity contracts based on forward prices (rather than spot prices), the proposal would require the banking organization to compute the delta capital requirement using the current prices for futures and forward contracts."[49]

Finally, we believe the correlation parameter for the gaseous combustibles and electricity commodity bucket should be recalibrated based on historical market data. For purposes of the proposed SBM framework, the B3EG Proposal would apply a correlation parameter of 65 percent with respect to transactions within the gaseous combustibles and electricity commodity bucket.[50] Based on public data

[45] Table 9 to §__.209 (proposed). This also would apply for purposes of SA-CVA. Table 9 to §__.225 (proposed).
[46] U.S. Energy Information Administration, "Natural gas explained" (last updated Apr. 28, 2023) (here).
[47] European Council, "Infographic - How is EU electricity produced and sold?" (last reviewed May 10, 2023) (here).
[48] European Council, "Infographic - Where does the EU's gas come from?" (last reviewed May 10, 2023) (here).
[49] 88 Fed. Reg. at 64,115.
[50] Table 10 to §__.209 (proposed).

presented in the table below, the historical correlation over the last several years for the gaseous combustibles and electricity ranges between 50 percent and 81 percent, with the most recent four-year average being 78 percent. We believe that the intra-bucket correlation parameter should be increased from 65 percent to 75 percent to more accurately reflect the historical volatility of these arrangements.

Table: Electricity and Natural Gas Evidence (2018-2022)[51]

Year Ahead	Annual Volatility		Implied Risk Weight		Correlation
Prices	Electricity	Natural Gas	Electricity	Natural Gas	Electricity vs. NatGas
2018	6%	8%	4%	5%	50%
2019	9%	9%	6%	6%	56%
2020	8%	12%	5%	8%	77%
2021	14%	17%	9%	11%	76%
2022	34%	30%	22%	20%	81%
2020-2022	**21%**	**21%**	**14%**	**14%**	**78%**

3. Residual Risk Add-On recommendation

The RRAO has a specific and limited purpose in FRTB SA. As designed by the Basel Committee, RRAO "provides a simple, conservative capital requirement for any other risks not addressed by the main risk factors included in the sensitivities-based method or standardised DRC requirement."[52] While we appreciate the role the RRAO plays in FRTB SA, we believe its application should be clarified where market risks in certain products are adequately captured by the SBM and DRC components of FRTB SA. Stated differently, RRAO should capture truly "residual" risks with SBM and DRC as the primary drivers of FRTB SA.

We appreciate the Agencies' effort in the B3EG Proposal preamble to identify certain products that would be subject to RRAO.[53] The B3EG Proposal is not clear, however, whether these identified products are an exclusive list or only indicative.

We encourage the Agencies to clarify in a final rulemaking that RRAO is presumptively inapplicable to volatility swaps, variance swaps and volatility target products—e.g., products dependent on future realized volatility and which generate meaningful SBM-based capital requirements. While we

[51] This table uses a liquidity horizon of 20 days, which is specified in the FRTB IMA rules for "Energy and carbon emissions trading price," and assumed 250 (trading) days in a year (and serial independence). We then converted to 99% tail (z-score of 2.33).
[52] FRTB Explanatory Note, p. 10.
[53] 88 Fed. Reg. at 64,128 n. 372.

appreciate that it may be impractical for the Agencies to give "bright-line" guidance—unanticipated features in a specific product could create risks that warrant application of RRAO—expanding the general guidance on standard product expectations would provide helpful clarification for implementation programs.

4. Term repo-style transaction recommendation

We support the position of the Joint ISDA-SIFMA Letter (Section I.A) that for term repo-style transactions ("**Term RSTs**") subject to a trading book election, only the risk to the funding curve should be included in the Market Risk-based charge, and securities collateral should be excluded from the Market Risk-based charge. The B3EG Proposal would modify how Market Risk capital requirements apply to certain Term RSTs.[54] Under proposed standards, a banking organization would still apply the collateral haircut approach ("**CHA**") and a Market Risk-based charge for interest rate risk on the financing leg of a Term RST. However, in a change, a banking organization would also be required to apply FRTB SA SBM and DRC calculations to the securities included as collateral in Term RSTs.[55]

As noted in the ISDA-SIFMA Letter, the risk of a negative change in the value of securities collateral is already adequately captured in the CHA and standard margining practices. A banking organization is only exposed to market risk in a Term RST based on the risk of fluctuations in the repo funding rate; it does not directly face market price risk or issuer default risk on the securities collateral. To the extent that a banking organization faces contingent counterparty default risk, that risk is already and separately included in the counterparty credit risk RWA charge. As long as its counterparty performs, the banking organization is not exposed to changes in the value of the securities collateral. Changes in the value of the securities collateral would be reflected in the margin a counterparty was required to post to the banking organization. Currently, Term RSTs are margined daily, and counterparties are required to re-margin even for overnight changes in collateral value. The banking organization would be exposed to changes to the value of securities collateral only in the event of its counterparty's default, since at that time the banking organization would take possession of the collateral to close out its position on a net basis. Any risk that the value of the securities collateral would decline during a closeout period such that the cash loaned to the counterparty would exceed the collateral value is already captured in the CHA through collateral haircuts.

5. Local currency liabilities recommendation

In some cases, a U.S. banking organization may hold in its trading book non-U.S. sovereign debt instruments denominated in the local sovereign's currency. Such positions attract market risk, given the risk in valuation changes of the position and should be capitalized accordingly. However, a banking organization should be permitted to offset DRC charges where it has offsetting liabilities denominated in the same non-U.S. sovereign's local currency. This recommendation is grounded in three considerations.

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[54] See 88 Fed. Reg. at 64,147; §__.205(g) (proposed).

[55] These charges, in particular the DRC, would be duplicative of the capital requirements for counterparty credit risk using the CHA in §__.121(c)(2)(i)-(iii), subject to the Market Risk volatility haircuts in Table 1 to §__.121 (proposed).

First, this treatment already applies in the banking book and would be retained going forward by the Expanded Approach Credit Risk framework. Existing Standardized Approach Credit Risk standards include an explicit mechanic that permits a banking organization to assign a credit risk weight that aligns with local country capital standards (generally zero percent, in the case of a local country sovereign exposure) if the banking organization has offsetting liabilities denominated in the local currency.[56] Since a banking organization might reasonably hold non-U.S. sovereign securities in either the banking book or the trading book, it would be logical to apply the same mechanic for offsetting local currency liabilities in both places equivalently.

Second, this treatment is justified on risk management grounds. While the SBM component of the FRTB SA calculation will capture general market risk in a non-U.S. sovereign security, the DRC is specifically designed to capture default risk. A non-U.S. sovereign, however, has no need to default on its local currency-denominated debt obligations, as it can devalue its currency to avoid default.

Third, this approach is consistent with the Basel Accord and implementation approaches in other major jurisdictions. The Basel Accord provides that, at national discretion, claims on sovereigns in the DRC may to be subject to a zero default risk weight in alignment with Credit Risk standards.[57] U.K. and EU authorities have each taken this approach in the current versions of their B3EG implementation frameworks.[58]

6. UMBS clarifications

We support the position of the Joint ISDA-SIFMA Letter (Section I.C) that the Agencies should clarify that securities in the to-be-announced ("**TBA**") market and deliverable pools that are eligible as Uniform Mortgage-Backed Securities ("**UMBS**") would be treated as the same obligor under SBM and DRC. In addition, UMBS and UMBS-ineligible Fannie Mae and Freddie Mac securities should be considered the same obligor if the issuer names are the same.

Market participants treat TBAs and deliverable pools as interchangeable exposures and each of TBAs and pools are generally used by market participants to hedge positions in one another. If the B3EG Proposal is implemented as drafted, UMBS and deliverable pools would be subject to higher capital requirements that are not justified by the underlying risks of these transactions, adversely affecting homeowners through higher mortgage costs.

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[56] 12 C.F.R. § 217.32(b)(3).

[57] Basel Accord, "Minimum capital requirements for market risk," Jan. 2019 (rev. Feb. 2019) (here), MAR22.7 and CRE20.7 to CRE20.15.

[58] See Bank of England, Credit Risk: Standardised Approach (CRR) Part, Article 114 published in CP16/22 (here) – Implementation of the Basel 3.1 standards, in conjunction with Capital Requirements Regulation (EU) 575/2013 (UK CRR) Article 114(7) (here); EU CRR Article 325y(2) and Article 114(7) (here).

H. Other FRTB SA technical recommendations

Similar to our technical recommendations for FRTB IMA, in a number of areas we recommend that the Agencies clarify or revise technical standards in FRTB SA. Adopting these clarifications and revisions would improve the accuracy and operational efficiency of FRTB SA.

1. *Treatment of credit and equity exposures to REITs*

We support the position of the Joint ISDA-SIFMA Letter (Section I.*I*) with respect to the treatment of real estate investment trusts ("**REITs**") in FRTB SA. The proposed credit spread risk ("**CSR**") delta buckets for non-securitizations and delta equity risk buckets generally do not address the treatment of equity positions and debt positions in REITs. For credit positions in publicly traded REITs, the banking organization would be required to apply a punitive risk weight risk. The credit spread non-securitization risk class also does not specifically mention real estate activities. There is no basis for the inconsistency between the credit spread risk non-securitization risk class and equity risk class.

The Agencies should revise the proposed CSR delta buckets for non-securitizations accordingly. A debt position to a REIT should be assigned to "Financials including government-backed financials" and this sector should specifically include "real estate activities" for consistency with the equity risk class.

2. *Credit spread risk for U.S. Treasury securities*

While we recognize that there is basis risk between U.S. Treasury securities and other risk-free curves in the United States, the proposed treatment of CSR for these securities is inconsistent with day-to-day risk management practice. Therefore, we support the position of the Joint ISDA-SIFMA Letter (Section I.B.1) and believe that these positions should not have a "credit spread" component but instead to be subject only to interest rate risk. The Agencies should revise the B3EG Proposal so that U.S. Treasury securities are treated as an interest rate curve with basis against other interest rate curves and pair-wise correlation of 99.9 percent.

3. *Credit spread risk for local currency sovereign securities*

For similar reasons to those cited above for U.S. Treasury securities, we support the position of the Joint ISDA-SIFMA Letter (Section I.B.2) that exposures to foreign sovereign securities in their local currency should not be subject to CSR charges and a banking organization should not be required to generate the credit spread risk sensitivities solely for purposes of Market Risk capital calculations. As with U.S. Treasury securities, the Agencies should revise the B3EG Proposal so that such exposures are treated as an interest rate curve with basis against other interest rate curves and pair-wise correlation of 99.9 percent.

4. *Treatment of certain bond indices*

The Agencies should allow banking organizations to treat bond indices that are well-known and well-diversified, but where the look-through approach is not possible—e.g., the Municipal Market Data (MMD) Index—as a specific index or sector index. Otherwise, banking organizations may be unable to recognize certain generally effective hedging arrangements.

5. *Index vs. ETF option vega*

For purposes of vega aggregation, an option on an ETF that references an index and an option on the same index should be treated as having the same issuer. ETFs referencing an index and an option on the same index reference the same underlier; therefore they effectively have the same volatility.

6. *Decomposition of Commercial Mortgage Backed Securities Index (CMBX) positions*

We support the position of the Joint ISDA-SIFMA Letter (Section I.P) with respect to the decomposition of securitization indices generally. More specifically, we recommend that the Agencies permit banking organizations not to decompose Commercial Mortgage Backed Securities Index ("**CMBX**") positions and include the position in the relevant CMBS bucket the position would typically be hedging.

While prices for the securitization indices are observable, the underlying constituents of the indices typically are not observable. As a result, banking organizations generally set the securitization tranche credit spread curve at the headline index instrument level and not at the level of the underlying constituents. Therefore, banking organizations should be permitted not to decompose the securitization index and instead reflect the total credit spread risk for these positions within the appropriate *delta* bucket for credit spread risk for non-CTP securitizations provided in Table 7 to §__.209.

7. *SBM Interest Rate Vega Tenor Assignment*

We support the position of the Joint ISDA-SIFMA Letter (Section I.N) with respect to the assignment of interest rate ("**IR**") vega tenors based on a banking organization's internal risk management models.

The B3EG Proposal would require banking organizations to assign IR vega to a specific tenor, which, in some cases, may differ from the banking organization's risk management model.[59] For example, for certain exotic options (including cancellable swaps), a firm's risk management model may assign vega maturity based on a replicated portfolio across multiple tenors. The B3EG Proposal's requirements for assigning vega maturity tenors could therefore result in insufficient recognition of hedges.

8. *RRAO for callable bonds*

While the B3EG Proposal specifies that callable bonds are not subject to RRAO if priced using a yield to maturity ("**YTM**") model, we believe this exclusion should apply regardless of whether a YTM model is used by a banking organization. YTD models are arguably less risk sensitive than alternatives, but the B3EG Proposal would incentivize firms to use YTM models, resulting in less effective risk management by banking organizations. Banking organizations might, for example, use either a YTM model or a stochastic model, with the latter being generally more in-line with post-financial crisis risk modeling practices as well as more risk-sensitive. Conditioning the exclusion of RRAO on use of a YTM

[59] See 88 Fed. Reg. 64,117.

model thus incentivizes firms to move away from stochastic models that, while more complex, are better suited for risk management.

9. *Flexibility on fallback capital requirement*

We support the position of the Joint ISDA-SIFMA Letter (Section III.I) with respect to narrowing the scope of the fallback capital requirement to exclude de minimis exposures. We recommend that the Agencies clarify that the fallback capital requirement is intended to apply to de minimis exposures, and not to occasional trade specific failures and clarify that bank organizations should be permitted to use (well documented) processes to account for trades / sets of trades that suffer a transient failure. For purely de minimis exposures, the B3EG Proposal should be revised to specify that the banking organization must have policies and procedures to address the use of the fallback capital requirement, subject to supervisory review and approval.

I. Other FRTB operational issues

Our suggestions in this Appendix include recommendations related to both FRTB IMA and FRTB SA. In addition to these points, there are operational issues within the broader FRTB framework that should be considered in any final rulemaking.

1. Internal Risk Transfer (IRT)

We support the position of the Joint ISDA-SIFMA Letter (Section III.B) that the Agencies should permit banking organizations to take trading intent into consideration in conjunction with other factors to determine the designation of Market Risk covered positions, and to restore the concept of internal risk transfer ("**IRT**") with respect to equity risk and aligning the requirements with that of credit risk exposure. The U.S. Market Risk framework should align with the Basel framework with respect to permitting hedging of equity positions in the banking book and IRTs within the trading book. This approach would permit a non-trading business to hold and hedge equity positions in the form of publicly traded equity securities and for these positions to be capitalized appropriately without the banking organization needing to move these positions to a business that would not otherwise hold or trade the positions.

2. Boundary - Re-designation standard

We support the position of the Joint ISDA-SIFMA Letter (Section III.F) that the B3EG Proposal should be revised to specify that error correction is not subject to the re-designation framework. A banking organization should be given a grace period in connection with internal controls and governance processes when determining the appropriate designation of Market Risk covered positions. If a banking organization identifies and corrects an error during this process, that re-designation should be viewed as a correction of the initial designation, not as a re-designation subject to an add-on.

3. Definition of a trading desk

The B3EG Proposal appears to contain contradictory guidance with respect to the type of allowable positions on a trading desk. On the one hand, a trading desk is referred to as "a unit of

organization . . . that purchases or sells market risk covered positions,"[60] but the B3EG Proposal preamble suggests that the desk structure was generally intended to be aligned with Volcker Rule standards.[61] However, the trading desk definition under the Volcker Rule does not contain a similar limitation, thereby permitting trading desks to buy and sell not only covered positions but also hold banking book positions. Examples of such activity include holdings of a public company's stock that has gone private, repo-style transactions, or other non-trading activities such as lending activity.

It would be operationally challenging for banking organizations to take steps to remove any banking book positions that might arise in the normal course a trading desk's operations, as summarized above. This issue could be resolved by adding a qualifier to the trading desk definition, as by modifying it to refer to "a unit of organization . . . that generally purchases or sells market risk covered positions." Furthermore, to the extent a trading desk is hedging banking book activity, it could create subdesks for purposes of adhering to IRT requirements.

4. Market Risk capture of structured notes' embedded derivatives

Many banking organizations routinely issue structured notes, which are hybrid funding instruments that consist of debt issuances with embedded derivative components. The preamble to the B3EG Proposal notes that if a banking organization accounts for the entire structured note position under a fair value option for accounting purposes, it should only include the instrument in Market Risk RWAs if there is trading intent or to hedge another Market Risk covered position.[62] While a banking organization may not have trading intent for the debt instrument itself, the embedded derivative and associated hedges should be captured as covered positions since they are subject to price fluctuations. This approach should be consistent with the revised trading book boundary that prohibits debt securities elected under the fair value option for purposes of ALM from being a covered position.

Further, the capture of embedded derivatives and related hedges in Market Risk RWAs should not be considered an IRT, irrespective of whether the risk associated with the derivative is interest rate, FX, commodity, equity risk or otherwise.

5. Implementation timeline

Our comments in this Appendix have summarized a wide range of complex FRTB issues that require resolution in any final rulemaking. Banking organizations' FRTB implementation programs cannot be completed until some of these issues are resolved. To permit adequate time for building necessary systems and related internal controls, we recommend that the effective date of any final revised Market Risk standards be not less than 12 months from publication of any final rulemaking in the *Federal Register*.

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[60] 88 Fed. Reg. at 64,102.
[61] 88 Fed. Reg. at 64,102 n. 270 ("The proposal would define trading desk in a manner generally consistent with the Volcker Rule.").
[62] 88 Fed. Reg. at 64,098.

Appendix 4: Credit Risk

The Credit Risk standards included in the B3EG Proposal include a number of improvements over the Standardized Approach Credit Risk framework by introducing more granular exposure categories and refining risk weights in some cases. As in the Standardized Approach, in the B3EG Proposal Credit Risk (combined with CVA) would remain the overwhelming bulk of total Expanded RWAs, giving outsized importance to the calibration of Credit Risk final standards. Accordingly, in our comments, we have highlighted key priority areas that may be expected to have significant impacts for our clients and markets if final calibrations do not align with risk management evidence.

A. High credit-quality corporates should be eligible for "investment grade" risk weights when supported by an adequate diligence record, regardless of whether the corporate has securities listed on an exchange

We support the proposed creation of a new 65 percent "investment grade" corporate risk weight category. The addition of this new category would better align banking organizations' risk management and capital management practices, since higher credit quality corporate exposures generally pose lower credit risk. The B3EG proposal also helpfully builds on the existing definition of "investment grade," which is well understood by risk professionals and bank examiners, providing a degree of certainty for how this new category should be applied.

We do not, however, believe that the investment grade corporate risk weight should be limited to exposures where the corporate counterparty has securities listed on an exchange. While the "securities listed" standard may provide one path for diligence to support an investment grade credit risk determination, we recommend that the Agencies permit banking organizations to rely on other reliable diligence records as well in making these determinations.

1. A wide range of high-credit quality corporates would be ineligible for "investment grade" treatment under the B3EG Proposal

Only a limited range of corporates in the United States—generally, publicly traded companies—have securities listed on an exchange. There are numerous examples of high credit quality corporates that elect not to list securities (e.g., privately held companies) or are unable to for legal or regulatory reasons (e.g., pensions, '40 Act funds). We believe that the Credit Risk framework should focus principally on the credit risk of the corporate and not automatically disqualify certain categories of high credit quality corporates from investment grade status based on a metric (listing status) that is not inherently tied to credit risk profile.

2. The introduction of new Operational Risk standards highlights the importance of Credit Risk calibrations

The introduction of a lower risk weight for investment grade corporate exposures would lower Credit Risk RWAs for such exposures from their current treatment in the Standardized Approach. This lower risk weight, however, must be considered in the context of newly added Operational Risk RWAs, which also apply to the same exposures that generate Credit Risk (or Market Risk) RWAs.

A banking organization's exposure to a high credit quality corporate client that does not have securities listed will not remain static with current Standardized Approach requirements. The banking organization will have to apply, for the first time, Operational Risk RWAs to the same exposure, raising the capital requirements for the exposure. Expanding eligibility for investment grade risk weight status is thus an important—and credit-sensitive—approach for mitigating the effect of additive Operational Risk RWAs.

3. Comparable and sufficient diligence records can be assembled without exclusive reliance on a securities listing requirement

The B3EG Proposal explains that "publicly-traded corporate entities are subject to enhanced transparency and market discipline as a result of being listed publicly on an exchange," and therefore the listing requirement would "complement a banking organization's due diligence and internal credit analysis, to determine whether a corporate exposure qualifies as an investment grade exposure."[1]

We agree with the Agencies that including the investment grade standard should include, as one eligibility criterion, whether a corporate has securities listed on an exchange. We believe, however, that this should not be the exclusive available diligence criterion. Instead, we believe that the Agencies should provide alternative criteria to that might supplement the core focus on credit quality analysis.

We recommend that any final rulemaking provide that an investment grade corporate exposure exists where the banking organization has concluded, based on an analysis of the corporate's credit risk, that it is investment grade and any of the following diligence records are established:

- The corporate has securities listed on an exchange.
- The corporate is a pension fund, an entity registered with the Securities and Exchange Commission under the Investment Company Act of 1940 or a foreign equivalent of either.
- In the case of a private corporate, such as a fund or private company, the corporate provides the banking organization with audited annual financials, quarterly financials and its offering memorandum (or similar governing document).

This multi-pronged approach has, in our view, two clear benefits. First, it broadens the eligibility criteria for investment grade corporates, resolving the effective prohibition on applying an investment grade risk weight to corporates, such as pension funds, '40 Act funds, real estate companies, utilities, insurance companies, and privately held companies. Second, this recommendation is simple, facilitates comparability across banking organizations, and is verifiable to auditors and examiners.

[1] 88 Fed. Reg. at 64,054.

B. The Agencies should retain the existing 100 percent risk category for certain non-significant equity investments

Since the inception of the U.S. implementation of Basel Accords more than three decades ago, U.S. banking organizations have assigned a 100 percent risk weight to a broad class of banking book equity exposures. While this treatment has been refined over time, the Agencies reaffirmed this core feature of the capital framework in 2013 when adopting the original Basel III Accord. Elimination of this risk weight category would not be a minor technical update to the regulatory capital framework. Banking organizations have numerous and diverse investments in this category, and any final rulemaking should consider the risk profile and loss history of each investment type.

We recommend that the Agencies either retain the existing 100 percent risk weight non-significant equity investment bucket for aggregate investments of less than 10 percent of total capital—and thereby permit banking organizations a degree of flexibility to manage their specific holdings within this bucket—or, alternatively, take a more tailored approach in which 100 percent risk weight treatment would apply to a specified but expanded range of investment categories. The first approach has the advantage of simplicity, avoiding the need for complex analysis across numerous investment categories and aligning the Expanded Approach with the Standardized Approach. The second approach, while more complex, would allow the Agencies to make more precise judgments about the specific investment categories eligible for 100 percent risk weight treatment. If the Agencies choose the second approach, we recommend that they significantly expand the range of investments eligible for 100 percent risk weight treatment and conduct a thorough impact analysis in support of final calibrations.

1. The 100 percent risk weight category supports a wide range of important investments by banking organizations

The Agencies included the 100 percent risk weight treatment in their 1992 final rule implementing the original Basel I Accord. As originally adopted, the 100 percent risk weight category applied to any equity exposure, without regard to significant or non-significant status and without it being subject to a quantitative cap.[2] The Agencies refined and limited the scope of the 100 percent risk category in their 2006 Basel II Accord final rulemaking, including by introducing the cap of 10 percent of total capital under one of the permitted approaches.[3] Following the financial crisis, the Agencies confirmed the 100 percent risk category, subject to the 10 percent of total capital cap, in their 2013 Basel III final rulemaking.[4] While there is a degree of nuance and complexity in the development of these standards over three decades, the core point is that the U.S. regulatory capital framework has always included, in some form, a broad-based category for applying a 100 percent risk weight to certain banking book equity exposures.[5]

[2] 54 Fed. Reg. 4186, 4208 (Jan. 27, 1989).
[3] 71 Fed. Reg. 55,830, 55,840 (Sep. 25, 2006).
[4] 78 Fed. Reg. 62018, 62,022 (Oct. 11, 2013).
[5] The risk weight applied to a non-significant equity investment is a distinct technical issue from deductions that are applicable when such investments exceed defined regulatory capital thresholds in accordance with Section 22(c) of the Agencies' existing Basel III standards.

In reliance on the stability of this treatment, banking organizations have used the current 100 percent risk weight category to support a diverse range of investments, including investments in, among other areas:

- Exchanges, clearinghouses and trading venues, including qualifying central counterparties ("**QCCPs**") and financial market utilities ("**FMUs**");
- Emerging financial technical companies;
- Wind, solar and other renewable energy projects;
- Inclusive venture program investments, including those led by led by underrepresented entrepreneurs; and
- Seed capital and carried interest in funds that are not Market Risk covered positions, in particular funds sponsored by the asset management divisions of banking organizations, which are subject separately to quantitative and qualitative limitations under the Volcker Rule.

2. The B3EG Proposal does not cite any evidence that would support reversal of a multi-decade approach to non-significant investment risk weights

The B3EG Proposal explains the proposed elimination of the legacy 100 percent risk-weight category for non-significant equity investments below 10 percent of total capital as designed to "to enhance risk sensitivity and simplify the equity framework."[6] There is no further explanation, including whether there is loss history evidence to suggest that banking organizations' reliance on the 100 percent risk weight has led to losses or poor risk management. The brevity of the rationale is notable, given both the well-established foundation of the existing treatment and the diverse range of investments included in it.

Beyond the RWA impacts in isolation, elimination of the legacy 100 percent risk-weight category may also have far-reaching implications for financial regulatory policy, such as discouraging banking organizations' investments in emerging financial technology companies, which help them stay competitive in a market landscape with fast-moving innovation. Similar considerations apply to banking organizations' relationships with (and investments in) QCCPs and FMUs.

The proposed elimination of the 100 percent risk weight category would raise challenges for banking organizations' strategic investment portfolios. Strategic investments are minority, non-controlling investments (as indicated by their inclusion in the non-significant investment category). They are long-term holdings with low portfolio risk profiles subject to governance and controls to prevent risky, speculative investments. Beyond their financial returns, these investments serve important purposes, including by improving the transparency and stability of financial markets; increasing

[6] 88 Fed. Reg. at 64,076.

competition, lowering costs and enabling greater market liquidity; and fostering innovation to drive efficiencies and better serve customers.

Morgan Stanley's strategic investment portfolio is diversified and has performed well over a multi-decade period, whether measured on a realized or unrealized return basis. While we cannot comment on the economic performance or risk management of other banking organizations' strategic investment portfolios, elimination of the 100 percent risk weight category would, we believe, introduce significant and unwarranted industry-wide frictions for all such portfolios.

3. If the 100 percent risk weight category for investments below 10 percent of total capital is eliminated, the Agencies should adopt 100 percent risk weights for certain market infrastructure, asset management and energy policy investments

We recommend that the Agencies retain the current 100 percent risk weight treatment for non-significant equity exposures whose aggregate adjusted carrying value does not exceed 10 percent of the banking organization's total capital. However, if the Agencies eliminate this category in any final rulemaking, we recommend that they consider clarifying that a 100 percent risk weight can be applied to specific categories of investments.

i. Market infrastructure investments

We believe that banking organizations' investments in QCCPs and FMUs should receive 100 percent risk weights. This treatment would align with existing practice (insofar as banking organizations manage these investments within the current 10 percent cap) and support the vital role these market infrastructure investments play in supporting vibrant and well-functioning markets. Significantly, QCCPs and FMUs generally have separate default funds to address clearing member default risk, with banking organizations' contributions to such default funds receiving separate, more conservative treatment under the capital framework.

ii. Inclusive venture program investments

Inclusive venture program investments are designed to discover, finance, and support companies founded and led by individuals who identify with traditionally under-represented, under-networked groups, including women and multicultural founders. These investments often are the first opportunity for these individuals and the companies they lead to gain access to capital markets, providing a crucial steppingstone in the advancement of the next generation of leading companies and emerging industries, while creating jobs and economic growth. Further, the increased visibility provided to these founders and their companies supports and advances the business case for broader initiatives in support of inclusion and representation across capital markets and corporate leadership positions.

iii. Asset management investments

Seed capital investments and carried interests, where applicable, are a critical component of an asset management franchise. Because these investments are non-significant, by definition they represent small holdings in a large fund advised by the asset management division of the banking organization. Any such seed investments must separately comply with applicable Volcker Rule standards, ensuring that banking organizations are not engaging in impermissible risk-taking. In addition, beyond seed capital invested in a fund, in some cases banking organizations will also include "carried interest" in this category. In these cases, the legacy 100 percent risk weight applies both to the seed capital invested in a fund as well as to the banking organization's economic gain from the original investment.

Elimination of the 100 percent risk weight bucket would, in many cases, result in reclassifying seed capital investments to 400 percent risk weights, as these investments are often made in funds that are not Market Risk covered positions. For example, under the B3EG Proposal, an exposure to a fund that has material exposure to certain non-trading positions (e.g., real estate holdings) as underlying assets remains in the Credit Risk, not Market Risk, framework.[7] Seed investments in this category (as well as related carried interest, if applicable) would be directly impacted by the loss of the 100 percent risk weight bucket.

This significant risk weight increase would, in all likelihood, act as a deterrent for banking organizations to grow these activities. There does not, however, appear to be a clear policy rationale for imposing this severe change. The Agencies adopted a final Volcker Rule framework a decade ago, implementing new statutory mandates to limit banking organizations' relationships with covered funds.[8] The B3EG Proposal cites no deficiencies with post-Volcker Rule regulatory standards that would suggest dramatic new efforts are required to further restrict banking organizations' seed capital investments in private funds.

C. The Agencies should adopt LTV-based mortgage risk weights that align with revised Basel Accord standards

We support the introduction of LTV-based mortgage risk weights. We believe there is compelling evidence demonstrating that lower LTV mortgages correspond with reduced credit risk.

We believe, however, that any final rulemaking should calibrate the LTV-based risk weights to align with revised Basel Accord standards. The B3EG Proposal applies, without empirical justification, 20 percent add-ons to each of the Basel Accord-defined LTV-based risk weights.

While the Basel Accord-defined LTV-based risk weights would result, for lower LTV portfolios, in reduce Credit Risk RWAs below those provided for in the Standardized Approach, this would not introduce unfair competitive dynamics with smaller banking organizations operating only under the Standardized Approach, for three reasons.

[7] §__.202 (definition of "Market Risk covered position," clause (2)(ix) (proposed).
[8] 79 Fed. Reg. 5536 (Jan. 31, 2014).

First, large U.S. banking organizations would be required under the B3EG Proposal to meet both Standardized Approach and Expanded Approach RWA requirements. As such, the Standardized Approach would remain a "floor" to the improved risk sensitivity of Expanded Approach mortgage RWAs.

Second, even if the Expanded Approach is considered in isolation, it will introduce new mortgage-related Operational Risk RWAs on top of LTV-based risk weights for Credit Risk, so a narrow focus on Credit Risk RWA calibrations is incomplete. In addition, large banking organizations are also subject to higher capital ratio requirements than smaller banking organizations, further underscoring that implementation of Basel Accord-defined LTV-based risk weights would not weaken safety or soundness or otherwise introduce a competitive imbalance.

Third, application of over-calibrated LTV-based risk weights will further accelerate the well-documented trend of the U.S. banking sector reducing its mortgage lending footprint. The structure of the U.S. mortgage lending market has evolved significantly since the financial crisis, with nonbank lenders playing an increasingly large role. While there are benefits to both bank and nonbank lenders providing financing to homebuyers (and competing with one another), over-calibrated LTV-based risk weights would introduce additional impediments to banking organizations' ability to service these markets and push even more financing activity to the unregulated nonbank sector.

D. The SFT haircut floor should not be included in the final rule

We support the policy objectives of the Agencies which motivated the inclusion of the SFT haircut floor in the B3EG Proposal. We agree that banking organizations should "require an appropriate amount of collateral to be provided to account for the risks of the transaction and counterparty."[9] We do not believe, however, that the proposed SFT haircut floor is a well-designed tool to achieve these objectives, and respectfully recommend that it be removed from any final rulemaking, which would align with policy decisions made in other major markets.

1. The B3EG Proposal does not cite evidence to explain why adoption of the SFT haircut floor is necessary

SFTs play a large and vital role in the functioning of U.S. capital markets. The Securities and Exchange Commission estimates, for example, that "the average daily dollar value of securities lending transactions is approximately $120 billion dollars."[10] Repurchase agreement (repo) financing markets operate at even larger scale. The Office of Financial Research estimates that "the U.S. repo market provides more than $3 trillion in funding every day."[11] The B3EG Proposal does not cite data explaining what portion of securities lending or repo transactions would be impacted by the SFT haircut floor. The scale of these markets and the potential for meaningful disruptions to them in response to blunt standards or incomplete analysis underscore the need for a careful approach in applying any floor.

[9] 88 Fed. Reg. at 64,064.
[10] 88 Fed. Reg. 75,644, 75,739 n. 1196 (Nov. 3, 2023).
[11] OFR, "Bilateral Repo Data Collection Pilot Project" (here).

We support well-regulated securities borrowing and repo markets. However, the B3EG Proposal does not identify a problem in the functioning of these markets that the SFT haircut floor is designed to solve. The Financial Stability Board ("**FSB**") originally envisioned, in 2015, the development of a global SFT haircut floor as a mechanism "to limit the build-up of excessive leverage outside the banking system, and to help reduce the procyclicality of that leverage.[12] But the B3EG Proposal does not explain the extent to which such leverage is a concern today in the United States; whether other post-crisis liquidity, funding and leverage-based capital standards sufficiently constrain U.S. banking organizations' ability to provide leverage in SFT markets; or whether application of the floor to U.S. banking organizations is the best mechanism to achieve the FSB's policy objectives.

We believe that any adoption of a floor in a final rulemaking should be based on analysis of publicly available data of these markets to ensure that it is well-designed to achieve its policy aims and will not disrupt normal course activities that do not raise policy concerns.

2. Adoption of the SFT haircut floor would introduce unnecessary complexity into the global operations of large U.S. banking organizations, since peer market jurisdictions have not proposed to adopt similar floors

The United States appears to be the only major market jurisdiction proposing to implement the SFT haircut floor, which would introduce two complexities for large U.S. banking organizations.

First, large U.S. banking organizations would be required to apply the floor to their global operations—including to their subsidiaries operating in foreign markets where local regulators have not adopted a floor. Application of the floor in this manner would be over-inclusive as applied to such non-U.S. subsidiaries, as any concerns with excess leverage in SFTs in non-U.S. markets would not be addressed since other local market dealers would operate without application of the floor.

Second, within U.S. SFT markets, the proposed floor would be underinclusive, as it would only apply to the financing operations of large U.S. banking organizations. Broker-dealers unaffiliated with banking organizations and smaller banking organizations would operate outside the floor's requirements, potentially pushing relevant financing activity deeper into shadow banking.

3. If the SFT haircut floor is adopted, it should be modified to more clearly exempt all securities borrowing transactions and written documentation requirements should be defined as including normal course transaction documents and related books and records

i. <u>Securities borrowing transaction exemption</u>

The B3EG Proposal includes an important exemption from the SFT haircut floor for "a transaction in which a [U.S. banking organization] borrows securities for the purpose of meeting a current or anticipated demand, including for delivery obligations, customer demand, or segregation requirements,

[12] FSB, "Regulatory framework for haircuts on non-centrally cleared securities financing transactions," Nov. 12, 2015 (here).

and not to provide financing to the unregulated financial institution."[13] We appreciate that the Agencies crafted this proposed exemption for inclusion in the B3EG Proposal as it does not directly align with the Basel Accord.

As a practical matter, the greatest potential challenges posed by the proposed SFT haircut floor would arise in the securities borrowing market. These transactions generally involve the borrower providing collateral to the securities lender, such as $102 of cash for $100 of securities borrowed. Because the cash exceeds the value of the securities borrowed and the securities themselves are often not exempt from application of the floor, any uncertainty or confusion over the application of the floor to these transactions could have meaningful market impacts, such as an inability to meet clients' securities transaction executions (in particular short sales).

We believe that the broad-based language in the proposed exemption—for the purpose of meeting a current or anticipated demand—should be applied in practice to effectively cover every securities borrowing transaction, including those conducted outside the United States by non-U.S. affiliates of large U.S. banking organizations. Local market securities borrowing conventions and associated legal and regulatory standards vary by jurisdiction, but we believe the focus should be on whether the transaction was conducted in accordance with applicable market rules to demonstrate that it was for the purpose of meeting a current or anticipated demand.

ii. Written documentation requirement

The securities borrowing exemption also includes a requirement that the banking organization must maintain sufficient written documentation that such transaction is for the purpose of meeting a current or anticipated demand.[14] Imposing bespoke written documentation requirements on the large, global securities borrowing market would introduce significant frictions. We believe that standard transaction documentation and related books and records should be deemed sufficient to meet the "written documentation" requirement, particularly since the B3EG Proposal does not provide any guidance on how this term should otherwise be applied.[15] Large U.S. banking organizations engage in securities borrowing transactions in all major jurisdictions, given documentation practices varying based on local market conventions and related legal and regulatory standards.

E. Exposures to highly regulated non-bank financial institutions should receive "bank" risk weights when these institutions are subject to Basel Accord-based prudential standards

Following existing precedents in the Standardized Approach, the B3EG Proposal would apply reduced Expanded Approach risk weights to a banking organization's exposures to a depository institution, a foreign bank, or a credit union.[16] We support reduced risk weights for "bank" exposures but

[13] §__.121(d)(2)(ii)(C) (proposed).
[14] §__.121(d)(2)(ii)(C) (proposed).
[15] See 88 Fed. Reg. at 64,064 (summarizing the exemption, including the written documentation requirement, but not explaining the scope of content of the requirement).
[16] §__.111(d) (proposed).

recommend that the Agencies clarify that these risk weights may also be applied to exposures to other highly regulated counterparties that are subject to Basel Accord-based prudential regulation.

1. Certain UK and EU nonbank financial institutions are subject to bank-based prudential standards

The B3EG Proposal would limit the application of "bank" risk weights to entities that formally meet the definition of a "bank." We agree with a limited and targeted application of "bank" risk weights, as only exposures to highly regulated entities subject to Basel Committee-compliant standards should be included in this category.

We recommend that the Agencies clarify the scope of entities included in the "bank" risk weight category to include nonbank EU entities subject to the EU's implementation of Basel Accord risk-based capital, leverage, disclosure, liquidity, and large exposure standards (CRR[17] and CRD[18]), notwithstanding that they do not engage in deposit-taking activities. Similarly, we recommend that the Agencies clarify the scope of "bank" to include certain UK non-credit institution (nonbank) investment firms designated for prudential supervision by the Prudential Regulation Authority under PS27/21 based on size and complexity considerations. In each case, these nonbank entities are subject to Basel Accord-based prudential standards applied as if the entities were banks.

2. Nonbank Swap Dealers are subject, in some cases, to capital requirements that incorporate the Board's RWA standards

The Commodity Futures Trading Commission adopted, in 2020, a capital framework for non-bank Swap Dealers.[19] This framework includes a "bank-based approach" in which a nonbank Swap Dealer may elect to calculate RWAs under the Board's capital standards and comply with minimum common equity tier 1 requirements designed by the CFTC to generally align with Basel Accord standards.[20] Banking organizations' exposures to these nonbank Swap Dealers may warrant application of "bank" risk weights or, as an alternatively, a risk weight between "bank" and general corporate exposures.[21]

[17] Regulation (EU) No 575/2013 as amended.
[18] Directive 2013/36/EU as amended.
[19] 85 Fed. Reg. 57,462 (Sep. 15, 2020).
[20] 85 Fed. Reg. at 57,491.
[21] See 88 Fed. Reg. at 64,054 (Question 39).

Appendix 5: Transitions

We appreciate that the Agencies provided a multi-year transition period in the B3EG Proposal before Expanded RWAs are applied at full calibration. Transition periods are an important prudential tool that allow for banking organizations to expand their capabilities in an orderly, time-limited, clearly defined manner to reach full compliance. We believe, however, that the Board should clarify how the SCB and G-SIB Surcharge apply during the transition period, particularly given the incorporation of RWA elements in each buffer calculation on a delayed basis.

Our specific transition recommendations are informed by three principles. First, the purpose of a transition period is to provide an orderly path to full application of revised regulatory standards. Accordingly, the mechanics of the transition period should minimize, to the extent possible, quarter-by-quarter or other interim period volatility in requirements.

Second, supervisors and investors will keep banking organizations focused on fully phased-in requirements. Accordingly, transition mechanics that create temporary additional capacity in a given quarter have limited practical significance, since the banking organization will remained focused on achieving its end-state requirements. Transition mechanics that include reasonable accommodations to smooth the path to fully phased-in requirements reinforce focus on building for end-state standards.

Third, since the SCB will continue to apply to the Standardized Approach at full calibration during the transition period, the significance of Expanded RWA transition period accommodations should not be overstated. Even generous-seeming accommodations for Expanded RWA requirements during the transition period will not increase banking organizations' capital capacity above their Standardized Approach-defined requirements, which will remain subject to the SCB and which will become more binding through incorporation of FRTB.

A. Issues to Solve for in the Transition Period

We believe that there are three distinct transition period issues to address. Each of these issues arises from the interplay of revised RWA standards with the Board's SCB and G-SIB Surcharge frameworks and could be addressed through targeted mechanical solutions that would reinforce the path to compliance with end-state, post-transition period requirements.

The first issue is the delayed incorporation of Expanded RWAs into the SCB and G-SIB Surcharge mechanics. For example, under the B3EG Proposal, the Expanded RWAs included in 2026 CCAR would reflect an 80 percent phase-in assumption, since that would be the applicable transition level as of December 31, 2025. However, the SCB resulting from 2026 CCAR will be applied to Expanded RWAs that are phased-in at 85 percent from October 1, 2026, to June 30, 2027, and at 90 percent from July 1, 2027, to September 30, 2027. Accordingly, if left unresolved, there will be a mismatch in phase-ins between Expanded RWAs and the buffers applicable to such Expanded RWAs.

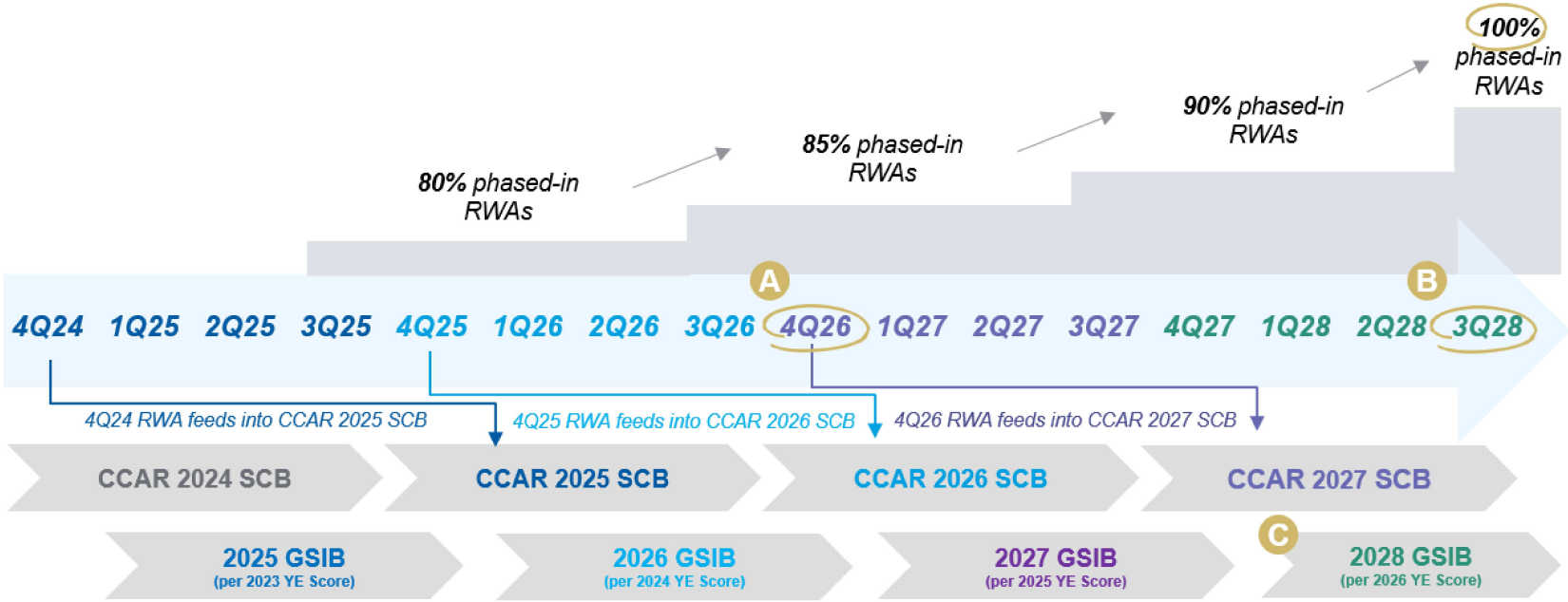
The second issue arises from setting the Expanded RWA transition date on July 1 each year while keeping the SCB date on October 1. A firm will potentially have three changes in its regulatory capital requirements in each year of the transition period—on July 1, October 1 and January 1 (for the G-SIB

Surcharge)—which could create significant and unnecessary capital planning and capital management uncertainties, particularly since upcoming changes in the applicable SCB are unknown before June in each annual cycle. (While the incorporation of Expanded RWAs into the G-SIB Surcharge raises similar mechanical issues, in practice we expect SCB-related frictions to be more pronounced.)

The third issue is how to calculate an SCB requirement (if any) on Expanded RWAs during the initial implementation period between July 1, 2025, and September 30, 2026. The Board will not be able to calculate an Expanded RWA-specific SCB until after the completion of 2026 CCAR, when Expanded RWAs will be included for the first time in supervisory stress testing. Moreover, even if the Board wanted to adjust the SCB for application to Expanded RWAs during this initial period, firms will not have completed initial regulatory reporting of Expanded RWAs until November 2025, raising questions about how a legacy SCB would even be adjusted for application to Expanded RWAs on the initial effective date of July 1, 2025.

When combined, these three issues create a complex quarter-by-quarter transition period, as summarized visually in the following chart.

Chart: B3EG Proposal Transition Period Mechanics



3Q28 Example:

A SCB uses 4Q26 RWA (@85% transition)

B Current RWA @100% phased-in fully effective

C GSIB surcharge potentially from 2026 year-end GSIB Score (RWA at 80% to 85% transition)

B. Apply a 2.5 percent CCB to Expanded RWAs during the transition period

Section C.2 of Appendix 1 of this letter explains our recommendation that a 2.5 percent CCB, rather than the SCB, apply to Expanded RWAs on a permanent basis. Accordingly, we also recommend that a 2.5 percent CCB apply to Expanded RWAs during the transition period, for similar reasons.

In addition, even if the Board determines that the SCB should apply to Expanded RWAs on a permanent basis, we believe that there are valid reasons for applying a 2.5 percent CCB to Expanded RWAs during the transition period, which extends through September 30, 2029. Applying a 2.5 percent CCB during the transition period would resolve the three issues identified in Section A of this Appendix 5. through a simple, elegant mechanism. While applying a 2.5 percent CCB to Expanded RWAs might appear to create for some firms the appearance of substantial excess capital capacity, supervisors and investors would keep banking organizations focused on end-state requirements. Further, as explained above, additional capital capacity under Expanded RWA requirements during the transition period would not result in actual additional capital capacity since firms would remain subject to SCB-governed Standardized Approach requirements.

C. If the SCB is applied to Expanded RWAs during the transition period, then the Board should adopt several mechanical adjustments to resolve frictions

While the simplest approach to resolving transition period issues would be to apply a 2.5 percent CCB to Expanded RWAs, the Board could also largely resolve transition period issues by making three related technical adjustments to the transition mechanics:

- First, incorporate Expanded RWAs into the SCB and G-SIB Surcharge calculations on a fully phased-in basis during the transition period.

- Second, move the Expanded RWA phase-in date from July 1 to October 1 each year to align with the annual revised SCB effective date.

- Third, apply a 2.5 percent CCB during the "stub period" between July 1, 2025, and September 30, 2026, to avoid the complexities of calculating an Expanded RWA-adjusted SCB at initial implementation.

The B3EG Proposal anticipates this recommendation, at least partially, by asking whether the SCB should be calculated during the transition period by assuming fully phased-in Expanded RWAs.[1] We believe a fully phased-in assumption for both the SCB and G-SIB Surcharge would be reasonable and justified as it would address the year-by-year RWA phase-in mismatch summarized in Section A of this Appendix 5 without disrupting firms' focus on compliance with end-state requirements.[2]

[1] 88 Fed. Reg. at 64,035 (Question 9).

[2] A more complex alternative approach would involve adjusting the incorporation of Expanded RWAs into buffer calculations on a year-by-year basis. For example, while Expanded RWAs will be included in 2026 CCAR with an

Similarly, moving the Expanded RWA phase-in date to October 1 in each year of the transition period would also be logical. It would reduce risks of temporary volatility in capital requirements arising from potential quarter-by-quarter changes. It would also ensure that the phase-in level of Expanded RWAs would be subject to a single SCB requirement during each year of the transition period. By contrast, as proposed, two different SCBs would apply to each phase-in level of Expanded RWAs. For example, 90 percent phased-in Expanded RWAs would be subject to both a 2026 CCAR-defined SCB (from July 1, 2027, to September 30, 2027) and a 2027 CCAR-defined SCB (from October 1, 2027, to June 30, 2028). Such timing mismatches create unnecessary complexity in capital planning during the transition period and could be resolved by revising the phase-in date to October 1.

Finally, while the Board could consider complex mechanics to solve for the "stub period" problem between July 1, 2025, and September 30, 2026, there does not appear to be a compelling reason to apply the SCB to Expanded RWAs during this initial period. Application of an SCB requirement to Expanded RWAs during this initial period would appear to require reliance on estimates of Expanded RWA impacts (since regulatory reported values will not be available on the initial effective date of July 1, 2025) combined possibly with immediate recalibrations of SCBs for the first three quarters of 2026 (after initial regulatory reporting of Expanded RWAs as of September 30, 2025, is available several weeks after the close of the third quarter, likely in November 2025). We believe application of a 2.5 percent CCB during this initial stub period would simplify the transition mechanics, improve planning certainty and avoid potential volatility in requirements.

80 percent phase-in assumption, the resulting start-to-trough capital ratio could be multiplied by 80/85 to scale it to match with an 85 percent phase-in for ERWAs.

Appendix 6: G-SIB Surcharge

We support the effort by the Board to update the G-SIB Surcharge framework through the G-SIB Surcharge Proposal. We are limiting our comments in this letter to certain technical issues in the G-SIB Surcharge framework.

A. Periodic revision of calibrations

The Board adopted the G-SIB Surcharge framework in 2015.[1] In explaining the complex mechanics of the Method 2 calculation, the Board observed that it relied on, in some areas, data from the 2011-2013 period and stated that it intended to periodically revisit calibration decisions.[2] While the G-SIB Surcharge Proposal includes a number of technical updates, the Board has not conducted a holistic assessment of the G-SIB Surcharge after almost a decade of operation.

We respectfully submit that three areas, in particular, warrant consideration in an updated analysis. First, the Board should consider the interplay of the SCB with the G-SIB Surcharge framework. The Board's 2015 white paper on the G-SIB Surcharge predated its adoption, in 2020, of the SCB final rulemaking, and each buffer plays a significant role in U.S. G-SIBs' risk-based capital requirements.[3]

Second, in some areas, the relative weightings of G-SIB Surcharge indicators do not align with the calibration decisions explained in the 2015 final rulemaking. The Board explained in 2015 that it adopted a "fixed conversion factor" in the Method 2 calculation "to weight the short-term wholesale funding amount such that the short-term wholesale funding score receives an equal weight as the other systemic indicators within method 2 (i.e., 20 percent)" based on 2013 data.[4] In practice, the short-term wholesale funding ("**STWF**") calculation far exceeds 20 percent for many firms, raising questions about whether the fixed conversion factor should be recalibrated with more current data to achieve its original stated target.

Third, we believe that the Board should reassess the design and calibration of Method 2 to reflect current regulatory standards. The 2015 final rulemaking stated that STWF calibrations were "developed using 2013 data on short-term wholesale funding sources from the FR 2052a."[5] Liquidity reporting data from 2013, naturally, would not reflect changes in bank holding companies' liquidity and funding management practices in response to the Liquidity Coverage Ratio ("**LCR**") and Net Stable Funding Ratio ("**NSFR**"), each of which took effect after that year. In addition, as discussed in Section D below,

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[1] 80 Fed. Reg. at 49,082.
[2] See 80 Fed. Reg. at 49,087 (explaining that "the aggregate global indicator amounts are converted from euros to U.S. dollars using an exchange rate equal to the average daily foreign exchange spot rates from the period 2011–2013"); 80 Fed. Reg. at 49,083 (noting that the Basel Committee "plans to review its [G-SIB Surcharge] framework . . every three years in order to capture developments in the banking sector and any progress in methods and approaches for measuring systemic importance").
[3] Board, "Calibrating the GSIB Surcharge," Jul. 20, 2015 (here).
[4] 80 Fed. Reg. at 49,100.
[5] Id.

changes in brokered deposit regulatory standards suggest that certain affiliate sweep deposits should no longer be captured as STWF.

B. The production of most on-balance sheet indicators could be achieved in an orderly manner by moving from monthly to weekly to daily cadences

We appreciate the Board's intention to move the production of G-SIB Surcharge indicators to daily average values. Moving production systems, however, to daily averages is a significant undertaking, which will necessitate in some cases building entirely new production capabilities, as legacy production systems are not designed to produce daily values. Implementation planning is also complicated by the fact that the G-SIB Surcharge Proposal does not include a specific target effective date, but instead refers to an effective date two quarters after adoption.

We recommend that the Board clarify that the effective date of the G-SIB Surcharge framework will be July 1, 2025 (or whatever other date the B3EG final rule is ultimately effective). Aligning the implementation timelines of these two rulemakings would reduce planning uncertainty and permit more efficient and integrated implementations.

We also believe that the Board should adopt a phased approach by which the production of most indicators would gradually transition from monthly to weekly to daily. We believe this is a reasonable accommodation that would allow banking organizations to design, test and implement necessary changes to production systems in an orderly manner. For consideration, we would propose the following schedule:

- On a monthly basis for the first twelve months (e.g., from July 1, 2025, to June 30, 2026, if the implementation dates of the G-SIB Proposal and B3EG Proposal are each July 1, 2025);
- On a weekly basis for the following twelve months (e.g., from July 1, 2026, to June 30, 2027, assuming a July 1, 2025, implementation date); and
- On a daily basis thereafter (e.g., beginning July 1, 2027, assuming a July 1, 2025, implementation date).

C. Level 3 assets and cross-jurisdictional indicators raise distinct calculation challenges and should not become subject to daily production

While we appreciate the Board's focus on the use of daily averages, in two areas we believe that production of daily averages is not practically feasible or would impose burdens on production systems that significantly outweigh the supervisory value of daily averages. For these two areas, we believe less frequent production of values would provide the Board with reliable data to appropriately compute G-SIB Surcharges.

1. Level 3 assets

Level 3 assets are, by definition, less liquid positions whose valuation requires consideration of inputs that cannot be validated exclusively with public market data. Accordingly, the valuation of Level 3

assets requires significant judgment with validation through appropriate controls and governance. Valuation methodologies include, as appropriate, consideration of liquidity risk (bid-ask adjustments), credit quality, model uncertainty, concentration risk and funding. Imposing a daily valuation requirement for Level 3 assets would thus be both meaningless (since all inputs cannot be reconfirmed on a daily basis) and burdensome (since valuation methodologies require intensive judgment and oversight). Accordingly, we believe that Level 3 assets are a distinct element of the G-SIB Surcharge calculation where reporting should remain based on quarter-end valuations.

2. Cross-jurisdictional indicators

Cross-jurisdictional indicators raise similar production issues that warrant non-daily reporting values. Recognizing the Board's focus on increasing the frequency of all indicators to the greatest extent possible, we believe it would be possible to produce cross-jurisdictional indicators on a monthly basis.

In current practice cross-jurisdictional claims and liabilities are populated by utilizing data from other reporting forms, some of which have reporting time lags of up to 50 days. Moving cross-jurisdictional claims and liabilities to more frequent reporting for G-SIB Surcharge purposes would thus not only increase production system demands but also require a fundamental reengineering of data production and control processes. Moreover, even after a reengineering, we do not believe it is feasible to complete all controls, reconciliations, adjustments and reviews of this complex data set on a daily basis. While any changes to the frequency of reporting cross-jurisdictional indicators should provide for an appropriate transition period, we believe the target future cadence for reporting these indicators should be not greater than monthly.

D. Sweep deposits should be excluded from Short-Term Wholesale Funding

The G-SIB Surcharge Proposal would "clarify" that sweep deposits remain STWF included in the Method 2 calculation notwithstanding recent changes to related regulatory standards that suggest an exclusion is warranted. We have two comments on this proposed clarification.

First, we believe that affiliate sweep deposit arrangements are more durable than other funding sources included in the STWF calculation and should, therefore, be excluded from this category. A conclusion that affiliate sweep deposits remain in the STWF category should be based on updated liquidity risk evidence.

Second, we respectfully disagree with the clarification on technical grounds. As originally adopted in 2015, the STWF component of Method 2 included "all brokered deposits held at the bank holding company provided by a retail customer or counterparty."[6] The term "brokered deposit [had] the meaning set forth in" the LCR.[7] In the Board's 2014 LCR final rulemaking, "brokered deposits" included "brokered sweep deposits."[8] When adopting the NSFR final rulemaking in 2020, the Board amended the LCR definitions to recognize a new category, "sweep deposits," which it specifically excluded from the

[6] 12 C.F.R. § 217.405(b)(2)(v).
[7] 12 C.F.R. § 217.401(d).
[8] 12 C.F.R. § 249.3; 79 Fed. Reg. 61,440, 61,524 (Oct. 10, 2014).

category of "brokered deposits."[9] In other words, the Board's regulatory framework suggests, on the one hand, that sweep deposits are not brokered deposits (for LCR purposes) but also, on the other hand, that they are brokered deposits (for STWF purposes) notwithstanding the STWF framework's stated reliance on LCR definitions.

[9] 12 C.F.R. § 249.3; 86 Fed. Reg. 9120, 9211-12 (Feb. 11, 2021).