



January 16, 2024

*Via Electronic Mail*

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

Federal Deposit Insurance Corporation  
550 17th Street NW  
Washington, D.C. 20429  
Attention: James P. Sheesley, Assistant Executive Secretary, Comments/Legal OES

Office of the Comptroller of the Currency  
400 7th Street, SW, Suite 3E-218  
Washington, D.C. 20219  
Attention: Chief Counsel's Office, Comment Processing

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (Federal Reserve Docket No. R-1813, RIN 7100-AG64; FDIC RIN 3064-AF29; Docket ID OCC-2023-0008)

Ladies and Gentlemen:

The Bank Policy Institute<sup>1</sup> and the American Bankers Association<sup>2</sup> appreciate the opportunity to comment on the joint notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency that would amend the capital requirements applicable to large banks<sup>3</sup> and those with significant

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<sup>1</sup> BPI is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. BPI's members include universal banks, regional banks and major foreign banks doing business in the United States. Collectively, they employ almost two million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

<sup>2</sup> The American Bankers Association is the voice of the nation's \$23.5 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2.1 million people, safeguard \$18.6 trillion in deposits and extend \$12.3 trillion in loans.

<sup>3</sup> In this letter, the term "bank" includes all banking organizations as defined in the proposal. See 88 Fed. Reg. at 64,030, note 1.

trading activity.<sup>4</sup>

## I. Executive Summary

If adopted, the proposed rule would have a profound effect on the availability and cost of credit for nearly every American business and consumer, as well as on the resiliency of U.S. capital markets. The U.S. economy would suffer a significant, permanent reduction in GDP and employment; U.S. capital markets would become less liquid, and therefore more dependent on non-bank intermediation in normal times and on governmental support when those non-banks step away from financial markets during times of stress. The precise potential impact on capital market liquidity is extremely complex to assess but would likely be significant for several segments of the market, with resulting harm to U.S. businesses, consumers and Americans saving for their retirement. Moreover, given the stakes involved, the proposal is remarkable for its conclusory assertions and lack of analysis, including its failure to consider both its costs and benefits, not just to banks but to all corners of the U.S. economy.

At a macro level, the proposal contains no standard by which to determine what an appropriate risk weight should be for credit risk and operational risk, and therefore makes it impossible to determine whether a proposed risk weight is too high or too low or whether the costs of higher capital outweigh the benefits. The absence of a standard is significant on two levels. On the one hand, if the agencies articulated a standard with a specific and particularly high probability that capital would be able to absorb any losses experienced over the course of a year, commenters might acknowledge that the proposed risk weights were consistent with that standard but object to the standard itself on the grounds that its economic and market functioning costs were too high. On the other hand, if the agencies articulated a specific standard with a lower probability that capital would be able to absorb losses over the same period, then commenters might acknowledge that such a standard represented a reasonable balance of costs and benefits but cite data to show that the risk weights in the proposal are, in fact, inconsistent with that standard. The current proposal leaves the public unable to do either: we cannot assess the appropriateness of a standard that was never disclosed, and we cannot assess the calibration of individual risk weights against a non-existent standard.

At a micro level, in almost every case the proposed risk weight for a given asset is based on no data or historical experience and no economic analysis. In most cases, the proposal simply takes as given the risk weights negotiated by agency staff in Basel over many years, resulting in the capital mandates released in 2017 and 2019, which, in turn, are lacking in data or analysis, or at least any that has been made public. In other cases, the agencies purport to rely on data they have not disclosed or on unverifiable “supervisory experience.” Also, in many cases, the agencies not only take Basel risk weights as a basis for the proposal but they then add arbitrary surcharges on top of the Basel weights, again with very little explanation. In all these cases, respondents are denied any meaningful opportunity to comment, as they do not know the standard used to develop the risk weights and the proposal generally provides them with no data or analysis on which to comment.

Because of the lack of supporting data and analysis for the policy choices in the proposal, we (and other members of the public) lack a meaningful opportunity to assess and comment on the methodology and the basis for many elements of the proposal.<sup>5</sup> In this letter, we attempt where possible to provide the

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<sup>4</sup> See Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. at 64,028 (Sept. 18, 2023).

<sup>5</sup> The substantial legal problems, both procedural and substantive, with the proposal are described in a

data and analysis that we would have expected the agencies to include in the proposal – such as data and analysis that can be used to produce risk weights based on risk of loss that reflects actual experience and other quantifiable standards. Where the agencies have access to the relevant data and we do not, we suggest analysis that could be undertaken to produce a coherent and empirically grounded proposal.

The proposed rule covers four categories of risk: credit risk, operational risk, market risk and credit valuation adjustment (“CVA”) risk. The risk weights applicable to each risk are substantially and unjustifiably overstated based on all historical experience of which we are aware. Since major reforms were instituted in the wake of the Global Financial Crisis, we have had over a decade of experience with the existing capital framework. By 2017, when the Basel agreement was reached, its authors concluded that no further increases in capital were required; rather, a key purpose of the revisions to the Basel framework finalized in 2017 was to reduce the variability of risk-weighted assets (“RWAs”) across banks. Since 2017, there has been no evidence that U.S. banks hold insufficient capital against the four risks addressed in the proposal. Much attention has focused, since March 2023, on the case of Silicon Valley Bank, but it did not fail due to credit, operational, market or CVA risk: its borrowers repaid their loans; it suffered no cyber-attack or other operational loss; and it did not trade derivatives or securities. Indeed, agency officials have acknowledged that its failure is not a basis for the significant increase in proposed capital requirements.<sup>6</sup>

Furthermore, with respect to operational, CVA and market risk, the proposal fails to acknowledge the existence of the Stress Capital Buffer (“SCB”) set by the Federal Reserve, which, in part, was designed to cover the same risks and results in higher capital charges with respect to operational, CVA and market risk. By not considering all components of the framework that determines bank capital requirements, the proposal effectively treats the calculation of RWAs as entirely distinct from the aspects of the framework establishing numerical ratio requirements, such as the SCB and Global Systemically Important Bank (“GSIB”) surcharge. But they are not distinct. Rather, RWA calculations and ratio requirements are inextricably linked in establishing bank capital requirements. RWAs also determine how much capital a bank must have to satisfy both minimum requirements and buffer requirements. Looking at and revising only one aspect of the bank capital framework, while effectively ignoring the interrelationship with the other, as the proposal would do, is a flawed and fragmented approach to the design and calibration of the bank capital framework.

### Credit Risk

#### *Standardized Risk Weights*

The proposed rule would establish a new “Expanded Risk-Based Approach” to which the SCB would be applied, and would make the binding requirement for large banks the higher of that approach and the existing Standardized Approach. It also would eliminate the Advanced Approaches that use bank models for credit risk.

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separate comment letter and are not discussed here.

<sup>6</sup> See, e.g., Statement by Travis Hill, Vice Chairman, FDIC, on the proposal to Revise the Regulatory Capital Requirements for Large Banks (July 27, 2023), available at <https://www.fdic.gov/news/speeches/2023/spjul2723b.html> (“It’s worth noting that implementation of the new Basel agreement was expected to result in no increase in required capital at any of the three banks that failed, but would result in major increases at several other Category IV banks.”).

With respect to the standardized risk weights, the most notable overstatements of risk in the proposed rule include the following:<sup>7</sup>

- Risk weights for credit card loans and other retail loans are substantially overstated.
  - For **credit card loans**, experience taken from regulatory reports supports a risk weight of 73 percent, whereas the proposal would impose an effective risk weight of 111 percent, to which would be added a further operational risk charge – combining for a total risk weight of approximately 140 – 190 percent, or roughly double what the actual risk justifies.<sup>8</sup> Notably, credit card loans – like all loans – may be subject to a further capital charge through the Federal Reserve’s stress test depending on the severity of the stress scenario, the composition of banks’ portfolios and the level of allowances for credit losses at the start of the tests. The combined charge is likely to increase the cost of credit for the millions of Americans who use credit card loans and could potentially make credit cards unavailable for many.
  - For **other consumer loans**, data from the Advanced Approaches supports a risk weight of 50 percent.<sup>9</sup> The proposal would introduce a risk weight of 85 percent, which is 10 percentage points higher than what the U.S. agencies agreed to in Basel and materially overstates the actual credit risk, particularly for auto loans. Moreover, other consumer loans may also face an additional surcharge through the stress tests, contingent on the severity of the scenario and the banks’ allowances for credit losses at the start of the stress tests.
  - The proposal would impose credit conversion factors (“CCFs”) on **unused credit card lines** based on no analysis and in conflict with historical data. The CCFs would increase the risk weights applicable to these lines of credit, incentivizing banks to reduce them – with particular harm to lower-income consumers who rely on unused lines as an emergency source of funding and as a way to build a credit history and gain access to other forms of retail borrowing such as mortgages.
  - Risk weights for loans where a bank offers relief to a borrower would rise to unjustifiably high levels. For example, in the case of auto loans to low- and moderate-income (“LMI”) borrowers and other borrowers who may be experiencing temporary financial hardship, banks may offer a one- or two-month extension to help customers stay current and avoid default and repossession. Under the proposal – based on no historical loss experience or analysis – this relief would be considered a default, and a 150 percent risk weight would apply to the loan. Banks would then have a powerful economic incentive to withhold such relief. There is no acknowledgment or consideration of this fact in the proposed rule.
- Risk weights for business loans are similarly overstated. According to the FFIEC 101 reports, documented historical experience from 2014 to 2022 suggests that a risk weight of 41 percent would be appropriate. The proposal establishes a general risk weight of 100 percent, with a 65 percent risk weight available only to businesses that are both rated investment grade by the bank and have

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<sup>7</sup> The examples listed below are indicative and not exhaustive.

<sup>8</sup> Paul Calem and Francisco Covas, *The Basel Proposal: What It Means for Retail Lending*, Bank Policy Institute (Nov. 8, 2023) [hereinafter *Retail Lending*], available at <https://bpi.com/the-basel-proposal-what-it-means-for-retail-lending/>, and attached as Appendix 2.

<sup>9</sup> *Id.*

securities listed on a national exchange or have a parent that does.

- The latter requirement would effectively impose a 100 percent risk weight, in addition to the charge for operational risk, on loans to tens of thousands of creditworthy small and mid-sized businesses that do not qualify as regulatory retail exposures, as well as high credit-quality, highly regulated mutual funds and pension funds that do not, as a normal part of their function, list securities on an exchange, either increasing their cost of credit or limiting their access to credit.
  - The proposal includes no analytical basis for the securities listing requirement. In fact, researchers using a robust data set have demonstrated that the listing requirement does not result in more consistent internal ratings across banks or lower credit risk, demonstrating that the requirement is arbitrary.<sup>10</sup>
  - Whether with or without a listed security, historical analysis based on FFIEC 101 report data from 2014 to 2022, combined with the Advanced Approaches risk weight formula, shows that a business rated investment grade by a bank merits a risk weight significantly below 65 percent, and below the 41 percent for all business loans – something on the order of 30 percent.
  - U.S. and international businesses alike would face higher borrowing costs, given the significant overstatement of the risk of those exposures and therefore uneconomically high capital charges that attach to them.
- Risk weights of loans to other banks are overstated relative to historical experience and the Basel standard. Historical experience based on data from FFIEC 101 reports from 2014 to 2022 supports a risk weight of 30.3 percent for loans to banks; the proposal would provide for a minimum 40 percent risk weight for exposures to banks in the highest grade,<sup>11</sup> regardless of the duration of the exposure. This overstatement of bank risk weights would reduce liquidity in repo markets, especially in times of stress.
  - Risk weights for mortgage loans would range from 40 to 90 percent, even before one considers the impact of the separate operational risk charge and the Federal Reserve’s stress test; for loans intended to be sold to government-sponsored enterprises (“GSEs”), the effective risk weight could be as high as 140 percent.<sup>12</sup> Documented historical experience based on data from the FFIEC 101 reports from 2014 to 2022 suggests an average risk weight of 25 percent is more appropriate. Indeed, research shows

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<sup>10</sup> See Francisco Covas and Barbora Stepankova, *Consistency in Risk Weights for Corporate Exposures Under the Standardized Approach*, Staff Working Paper – Bank Policy Institute (Jan. 2022), available at <https://bpi.com/wp-content/uploads/2022/01/Consistency-in-Risk-Weights-for-Corporate-Exposures-Under-the-Standardized-Approach.pdf>, and attached as Appendix 3.

<sup>11</sup> The proposed rule separates banks into Grades A, B and C depending on several factors, including, for example, whether the bank is investment grade and whether it meets applicable minimum capital requirements. See 88 Fed. Reg. 64,041.

<sup>12</sup> See Paul Calem and Francisco Covas, *The Basel Proposal: What It Means for Mortgage Lending*, Bank Policy Institute (Sept. 30, 2023) [hereinafter *Mortgage Lending*], available at <https://bpi.com/the-basel-proposal-what-it-means-for-mortgage-lending/>, and attached as Appendix 4.

that the risk weights in the proposal – even leaving aside the operational risk and stress test add-ons – assume loss rates higher even than the loss rates suggested by subjecting current bank mortgage portfolios to the stress undergone by GSE loans from 2005 to 2008.<sup>13</sup> The risk weights in the proposal would unjustifiably increase the cost and decrease the availability of mortgage credit to consumers, and particularly LMI and minority borrowers, who face the largest charges, as discussed further in Section IV.A.9.

#### *Internal ratings-based risk weights*

Compounding the effect of punitive standardized risk weights, the proposal would eliminate the Advanced Approaches for credit risk, effectively imposing a de facto 100 percent output floor for U.S. banks as opposed to 72.5 percent as negotiated in Basel. There is no evidence that internal models for credit risk have led to a systematic understatement (or overstatement) of risk at any bank. In fact, since 2014, banks have successfully used internal models to gauge credit risk for capital purposes, subject to backtesting and model approval from an independent risk function, an independent model validation group, internal auditors and agency examiners. The virtue of internal models is that they are inherently more granular and risk-sensitive than government-imposed, one-size-fits-all standardized methodologies; they can also be adjusted over time to reflect changing behavior.

- Ending the use of internal models for credit risk greatly increases the costs of over-calibration of standardized risk weights. In every other major jurisdiction implementing the 2017 Basel agreement, those standardized risk weights have not been surcharged; more importantly, they are effectively discounted given that in most cases internal models or external credit ratings (the use of which is not permitted in the United States) will produce a lower capital charge. If the U.S. were to eliminate internal models for credit risk and maintain a level playing field, it would need to recalibrate and substantially reduce standardized risk weights compared to those in the Basel framework. This outcome could be achieved by basing those risk weights on empirical evidence, as described in this letter.
- Additionally, ending the use of internal models for credit risk, and failing even to use it as a basis for calibrating the Expanded Risk-Based Approach, represents a repudiation of the core element of the 2017 Basel agreement that the agencies purport to be implementing.<sup>14</sup> That agreement's most negotiated and prominent feature was the continued use of bank models subject to an "output floor," meaning modeled outcomes cannot collectively produce RWAs lower than 72.5 percent of those calculated using a standardized approach. In this respect, the standardized approach was not designed or calibrated to be the primary determinant of credit risk capital. The agencies do not even note the

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<sup>13</sup> See Laurie Goodman and Jun Zhu, "Bank Capital Notice of Proposed Rulemaking – A Look at the Provisions Affecting Mortgage Loans in Bank Portfolios," Urban Institute (Sept. 2023), available at [https://www.urban.org/sites/default/files/2023-09/Bank percent20Capital percent20Notice percent20of percent20Proposed percent20Rulemaking.pdf](https://www.urban.org/sites/default/files/2023-09/Bank%20Capital%20Notice%20of%20Proposed%20Rulemaking.pdf).

<sup>14</sup> The Basel framework contemplates the continued use of internal models for credit risk. Although the Basel Committee provides that implementing only the standardized approaches would not, in and of itself, constitute noncompliance with the Basel framework, see Basel Committee on Banking Supervision, *High-level summary of Basel III reforms*, 12 (Dec. 2017), available at [https://www.bis.org/bcbs/publ/d424\\_hlsummaryv.pdf](https://www.bis.org/bcbs/publ/d424_hlsummaryv.pdf), nothing in the Basel framework requires the elimination of internal models for credit risk, and implementing the Basel standards in the United States in no way necessitates the elimination of internal models for credit risk.

existence of this component of the Basel agreement.

- In effect, having negotiated in Basel an output floor of 72.5 percent, the agencies now propose a de facto output floor of 100 percent but only for U.S. banks, and with the standardized approach that forms the basis of that output floor set even higher than the Basel agreement in almost every major respect.
- The effects of that choice are even greater than the top-line numbers suggest: the 72.5 percent output floor is an average, and that means some loans in other jurisdictions could receive risk weights significantly lower than 72.5 percent of the risk weight the same loan would receive under the U.S. Expanded Risk-Based Approach. For U.S. banks only, every loan would be subject to the full 100 percent floor under the proposed Expanded Risk-Based Approach and the current Standardized Approach. Thus, for lower-risk activities, U.S. banks will be at a serious competitive disadvantage compared to foreign peers, impeding the maintenance of a level playing field across jurisdictions.

### Operational Risk

If the proposal were adopted without change, large U.S. banks would end up holding over \$300 billion in capital against “operational risk.” This capital charge results because the proposed rule would, together with the stress capital charge, create more than \$3.5 trillion in phantom assets to represent operational risk, which, unlike credit and market risk, is not based on actual assets held by banks, and then impose a capital charge against those assets. For capital purposes, approximately 24 percent of banks’ collective RWAs would stem from these phantom assets. Based on analysis released by the banking agencies, the new operational risk charge accounts for nearly 90 percent of the increase in banks’ capital requirements under the proposed rule.

This requirement is massively overstated, and the agencies provide no basis for it in the proposal. This overstatement of risk is the product of multiple, fundamental errors in the proposal.

- As a threshold matter, the proposal breaks from current practice and imposes a standalone operational risk charge as part of a standardized approach to calculating RWAs that is also subject to stress-based capital requirements, ignoring in the process that capital held for purposes of credit and market risk can also cushion against operational risk. The proposed rule’s approach involves summing RWAs arising from credit risk, market risk, operational risk and CVA risk – in effect, presuming that extreme losses relating to credit, market, operational and CVA risk will all occur simultaneously, with a correlation of 1.0. That presumption is without historical precedent and is a fatal flaw of the proposal. There is no historical evidence that the timing of recognizing operational risk losses in bank earnings, and therefore capital, correlates with the timing of recognizing losses relating to financial risks (credit, market and CVA) otherwise capitalized by the proposal. Fines or judgments against banks for anti-money laundering and sanctions compliance, antitrust violations and consumer credit practices – which now make up the largest operational risk loss events – seemingly have very little correlation with credit and market loss events. The only case where there appeared to be some correlation involved penalties for mortgage practices in connection with the credit losses of the Global Financial Crisis. However, in reality, there is a material timing mismatch between the large operational risk losses that occurred during the GFC and credit and market risk losses because the actual loss to the bank was generally recognized several years later. In practice, this means that any estimate of operational risk capital needs to be substantially discounted.

- The proposal also fails to acknowledge that U.S. banks are already required to capitalize for operational risk through the Federal Reserve's stress test. The proposed rule would create \$2 trillion in phantom operational risk assets; another \$1.5 trillion in phantom assets (effectively) already results from the SCB that is calculated in the Federal Reserve's annual stress test, whose latest iteration assumed \$188 billion in aggregate operational risk losses. The combination of both minimum requirements and stress buffer requirements results in massive over-capitalization for operational risk, even assuming perfect correlation with other risks.
- The proposal ignores relevant data in calibrating the operational risk capital requirement. As described in detail below, a recent study shows that, based on 20 years of actual loss data for U.S. banks, the proposed operational risk charge, in combination with the existing SCB charge, assumes operational risk losses that are multiples of the largest losses experienced by banks in any year over that 20-year period, which includes all litigation losses associated with the Global Financial Crisis.

The agencies could have obtained access to loss data through the regulatory FR Y-14Q dataset that includes information on operational loss amounts, loss classifications and loss descriptions since the early 2000s. However, there is no indication in the proposal that they made use of it, resulting in an approach to operational risk that is seemingly arbitrary and unsupported by data.

- One source of the overstatement of operational risk is a material over-capitalization for the risk arising from fee-related income. Unlike the calculation of the interest component and the financial component of the business indicator for operational risk, the services component does not offset revenues with expenses. There is also no upward limit on the size of the services component; in contrast, for the interest component, there is a cap set at 2.25 percent of interest-earning assets. This method of deriving operational risk RWAs disincentivizes banks from diversifying their income streams away from net interest income and runs counter to sound risk management practices.

This problem has an outsized effect on U.S. banks, which have a higher proportion of fee-oriented banks than other jurisdictions, especially when including Category III and IV banks and considering the recent trends in the evolution of U.S. banks' fee income. As detailed in this letter, 12 of the 15 banks with the highest noninterest income relative to RWAs are subject to U.S. capital rules. Thus, it is surprising that this flaw in the 2017 Basel agreement did not receive attention in the proposal.

- The vastly overstated base operational risk charge in the proposal is, in turn, subject to a bank-specific "internal loss multiplier" ("ILM") floored at one, designed to assess whether that bank's individual operational risk loss history differs from the norm. There are two major problems with this approach. First, the proposal reflects a belief that unfavorable loss experience is relevant and should raise a bank's capital charge but simultaneously indicates that favorable loss experience is irrelevant and cannot lower that very same charge. Second, past operational loss events are not, in fact, a reliable predictor of future operational risk losses. As the United Kingdom regulators (along with regulators in the European Union) found in rejecting the multiplier, many operational loss events are "low-probability high-impact events," which, given their heterogeneity, "are generally not good predictors of other unlikely events and therefore future losses." Furthermore, the multiplier is based on data from the previous 10 years, but the "information value of operational risk losses generally diminishes over time as business models and lending activities

change.”<sup>15</sup> The proposal does not address these concerns and therefore lays out a fundamentally flawed approach to capitalizing operational risk.

As detailed below, there are numerous other components of the operational risk charge that are based on no data or analysis and result in a significant misstatement of the risk of various financial activities. The current proposal with respect to operational risk capital needs to be thoroughly reconsidered and re-proposed with a lower calibration, and once it is adopted, the operational risk component of the Federal Reserve’s stress test needs to be eliminated.

### Market Risk

The proposed rule would produce outsized increases in market risk capital despite no indication that firms have undercapitalized those activities, including during numerous recent periods of market stress. According to the proposal, market risk RWAs are expected to rise 77 percent for Category I and II bank holding companies. The increase results from the proposal to require market risks to be capitalized using either a standardized approach that, among other problems, does not sufficiently recognize the benefits of diversification, or a models-based approach that determines a substantial part of the capital requirement through a draconian stress test. Additionally, the eligibility requirements for the models-based approach lack empirical support and have the potential to introduce volatility and uncertainty into capital requirements, as banks could be forced to switch between applying models-based and standardized approaches due to the inability to “pass” arbitrary tests.<sup>16</sup>

Even more concerning, the proposed rule completely ignores that overall capital requirements for market risk are set through both the regulatory capital rules (which the proposal would revise) and the Federal Reserve’s annual stress test and resulting capital charge (the SCB), in particular the use of the Global Market Shock (“GMS”) component of the Federal Reserve’s stress test. Both the GMS and FRTB assess market risk under extreme stress conditions and assume prolonged periods of illiquidity during which banks are unable to hedge or close out positions. Therefore, implementing the new market risk rule without adjusting the GMS in the stress tests would lead to a considerable over-capitalization in the capital requirements for market risk.

If adopted, the proposal would harm U.S. capital markets, given the important role banks play in those markets. An unjustified increase in market risk capital requirements would raise the cost of debt and equity financing while reducing market liquidity. The increase in the costs of debt financing and hedging activities would translate to increased prices for consumers as they purchase homes, automobiles or other goods and services.<sup>17</sup> In addition, the proposal would reduce the liquidity of the U.S. capital markets,

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<sup>15</sup> Bank of England, *CP16/22 – Implementation of the Basel 3.1 standards: Operational risk*, (Nov. 30, 2022), <https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards/operational-risk>.

<sup>16</sup> See Greg Hopper, *The New Profit and Loss Attribution Tests: Not Ready for Prime Time*, Bank Policy Institute (Dec. 14, 2023), available at <https://bpi.com/the-new-profit-and-loss-attribution-tests-not-ready-for-prime-time/#:~:text=In%20light%20of%20these%20fundamental,reporting%20and%20monitoring%20purposes%20only>, and attached as Appendix 5.

<sup>17</sup> With respect to the increased costs of hedging that would result from the proposal, see David Murphy and Sayee Srinivasan, *Capital proposal: Endgame for a robust U.S. derivatives market?*, ABA Banking Journal, available at <https://bankingjournal.aba.com/2023/11/capital-proposal-endgame-for-a-robust-u-s-derivatives-market/>, and attached as Appendix 6 (“It is highly likely that banks will react to these proposals, if

which would drive up the cost of funding for American businesses and negatively affect investment and retirement savings for millions of Americans.

The treatment of CVA risk would exacerbate the adverse effects on banks' trading activities. Currently, CVA is included only in the Advanced Approaches; because the current capital regime does not apply the SCB to the Advanced Approaches capital ratios, the RWAs resulting from the Advanced Approaches generally are not the binding capital requirements for banks with significant trading activities. The proposal would fundamentally change the treatment of CVA risk by including CVA in the Expanded Risk-Based Approach RWAs, to which the SCB would apply. By the agencies' own analysis, taking into account market RWAs, CVA RWAs and operational risk RWAs the agencies attribute to trading activities, RWAs for trading activities would more than double, increasing by 157 percent.

### Tailoring

The proposed rule, in conjunction with other rules proposed over the summer, would have the practical effect of repealing the tailoring provisions of the Economic Growth, Regulatory Relief and Consumer Protection Act of 2018, at least with respect to capital and related requirements. Although the agencies certainly have the right to identify to Congress laws with which they disagree, they lack the authority to override Congress and must implement all statutory mandates. Although the regional banking turmoil of 2023 may merit some change to the law, Congress has not enacted any such changes; rather, through their actions the agencies have assumed the lawmaking process.

The proposed rule would largely apply the same capital requirements to banks in Categories I through IV, namely by (i) requiring banks in Categories I through IV to calculate RWAs in the same manner, including by requiring Category III and IV banks to move to the dual-stack approach previously only required for Category I and II banks; (ii) requiring Category III and IV banks to recognize unrealized gains/losses on available-for-sale ("AFS") debt securities and most other elements of accumulated other comprehensive income ("AOCI") in regulatory capital; (iii) requiring Category III and IV banks to apply the capital deductions and minority interest treatments that currently apply to only Category I and II banks; (iv) applying the Supplementary Leverage Ratio ("SLR") and countercyclical capital buffer ("CCyB") to Category IV banks; and (v) requiring all Category I through IV banks – regardless of the extent of their trading activities – to calculate market RWAs under the revised market risk capital rule. Some of these changes conceivably could be justified as a reaction to events of March 2023; the majority, however, bear no relation. Furthermore, even where change is deemed necessary, the agencies have failed to tailor requirements and instead have opted to treat mid-sized banks the same as GSIBs. In particular, requiring Category IV banks to apply a dual-stack approach – meaning those banks must calculate their capital ratios using both the current U.S. Standardized Approach and the Expanded Risk-Based Approach, with the lower of the two being the binding capital requirement – would impose undue costs and burdens without a commensurate supervisory or policy benefit.

### Summary

This proposal is the most radical transformation of bank regulation in the last decade. The largest banks in the country, which represent 80 percent of total bank assets, would be forced to increase their capital materially – by the Agencies' estimate, by 16 percent on average. The industry's estimates show a

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finalized, by increasing fees for providing market access, reducing the amount of risk that they allow clients to transfer, and refusing to provide access at all to the least profitable clients.").

far greater impact, with many banks estimating an increase of over 20 percent and with the GSIBs needing to increase capital by 25 percent.<sup>18</sup> In particular, banks with higher levels of fee income may see their capital requirements surge by more than 50 percent due to the new operational risk charges. Furthermore, trading assets are set to experience a capital requirement increase of over 70 percent.

This extraordinary increase in capital charges – both overall and in individual products and sectors – is not justified in the proposal by any adverse developments in the banking sector, and we are unaware of any justification. In particular, it is widely accepted, including by the regulators, that the bank failures in 2023 were not caused by inadequate capital. Nor does the proposal seek to explain in any concrete detail why any of the individual proposals for capital charges are more closely aligned with the risk in the particular component than the current risk requirement. In the absence of a demonstrated need for a sharp change in capital requirements, there should be a substantial burden of proof on the agencies to justify those changes. The agencies are far from carrying that burden of proof.

The current banking model is not broken, but the proposal creates a risk of breakage. As the agencies have acknowledged, the banking system has been strong and resilient in confronting recent macro-economic challenges. The industry built capital and liquidity to prepare for those eventualities. The capital build required by the proposal, however, would be far more demanding and would inevitably force banks out of certain business lines, require them to charge higher prices and fees, and reduce the number of marginal customers – all to the detriment of the Americans saving for their retirements, consumers of goods and services, small businesses, companies seeking access to the capital markets, businesses seeking to hedge risk, pension funds and even smaller banks not subject to the proposal – ultimately, the entire American economy.<sup>19</sup> The agencies should require far more justification than what is in the proposal to risk that result.

We urge the agencies to fundamentally reconsider this proposal and conduct a rigorous and comprehensive assessment of the first- and second-order consequences that changes to the capital framework could cause. We highlight specific issues for further consideration throughout this letter.

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<sup>18</sup> See Letter from the Financial Services Forum, American Bankers Association, Bank Policy Institute and Securities Industry and Financial Markets Association to Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System, James P. Sheesley, Assistant Executive Secretary, Federal Deposit Insurance Corporation, and Chief Counsel's Office, Office of the Comptroller of the Currency (Dec. 22, 2023), available at <https://www.sifma.org/wp-content/uploads/2023/12/Associations-Letter-re-B3E-Impact-on-U.S.-GSIBs.pdf>.

<sup>19</sup> A survey of BPI and ABA banks, discussed in detail in Appendix 1, reveals that banks expect the proposal to reduce their ability to meet the needs of customers across almost every category.

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Appendix 1 (*ABA and BPI Member Survey*)

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Appendix 9 (*A Better Way to Conduct the Economic Impact of the Basel Proposal*)

Appendix 10 (*The Basel III Endgame Proposal: Yet Another Gift to Private Credit Funds*)

Appendix 11 (*The Federal Reserve Should Revise the U.S. GSIB Surcharge Methodology to Reflect Real Risks and Support the Economy*)

Appendix 12 (*How Can The Global Market Shock More Effectively Complement the Fundamental Review of the Trading Book?*)

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Appendix 14 (*About Excessive Calibration of Capital Requirements for Operational Risk*)

Appendix 15 (*Estimating the Implicit Capital Charges in the Stress Tests*)

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Appendix 17 (*A Modification to the Basel Committee’s Standardized Approach to Operational Risk*)

Appendix 18 (*Template and Instructions for the Operational Risk QIS*)

**II. Due to analytical deficiencies in the proposal’s assessments of both its potential benefits and its potential costs, the agencies must revise the analysis and significantly recalibrate the framework to limit the unjustifiable effect on overall capital requirements.**

The proposal includes an “Impact and Economic Analysis” section of approximately 16 pages out of 1,087 total that describes how the agencies “assessed the impact of the proposal on bank capital requirements and its likely effect on economic activity and resilience.”<sup>20</sup> With respect to the benefits of the proposal, the central conclusion of the analysis is that “[o]n balance, [the academic literature on optimal capital levels] concludes that there is room to increase capital requirements from their current levels while still yielding positive net benefits.”<sup>21</sup> But the academic literature cited does not, in fact, support this conclusion, and the proposal’s analysis does not attempt to independently quantify the benefits the agencies expect from the proposal. With respect to the costs, the analysis separately estimates the economic impacts on lending activity and trading activity, but the analysis overlooks significant drivers of additional cost in both areas and also costs related to other financial activities widely undertaken by banks. In light of these deficiencies in the proposal’s economic analysis, the significant increase in capital requirements that the proposal would cause is not appropriately justified. The agencies must perform a revised analysis to correct these deficiencies and recalibrate the capital framework significantly downward prior to issuing a final rule.

**A. Current bank capital levels are above the midpoint of the range of optimal estimates cited in the proposal and are close to the upper end of recent academic estimates.**

The proposal justifies the substantial increase in aggregate capital requirements with the claim that “current capital requirements in the United States are toward the low end of the range of optimal capital levels described in the existing literature.”<sup>22</sup> To support this assertion, the proposal cites seven

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<sup>20</sup> 88 Fed. Reg. at 64,167.

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 64,169.

papers in a footnote. Of these, five papers suggest bank capital levels ought to be higher than they are currently, whereas two papers argue for lower optimal capital requirements. However, the cited analysis does not, in fact, support the proposal's assertion that current requirements are toward the low end of the range of optimal levels for two reasons. First, two of the seven papers cited do not provide estimates for optimal capital levels. Second, although the proposal refers to "existing literature," the agencies failed to conduct a comprehensive review of the seven papers they selected and also did not include some of the recent academic journal publications that suggest optimal capital levels are lower than current levels in the United States.

As of the end of the second quarter of 2023, the common equity tier 1 ("CET1") risk-based capital ratio, the best regulatory measure of loss-absorbing capacity on a going-concern basis, for all U.S. bank holding companies stood at 12.8 percent. Based on the papers cited in the proposal, the range of optimal estimates varies between six percent and 17.5 percent, with a midpoint of 11.8 percent.<sup>23</sup> Thus, even the studies cited in the proposal do not support the agencies' assertion that current capital requirements in the United States are toward the "low end" of the range of optimal capital levels.

Furthermore, the agencies should give more weight to the results of recent academic studies, which offer a more comprehensive analysis of the costs and benefits of higher capital requirements and are calibrated to match various data features, both in terms of macroeconomic quantities and prices.<sup>24</sup> In these frameworks, the primary benefit of higher bank capital is a reduced probability of bank failure and therefore higher GDP from lower bankruptcy costs. In contrast, the main cost of higher capital requirements is a smaller banking sector, resulting in decreased business borrowing and investment, along with a decline in GDP. The optimal level of bank capital is that which maximizes lifetime consumption for households in the economy.

These more recent and comprehensive academic papers, several of which are not cited in the proposal, provide estimates of optimal capital ratios that range from six percent to 14.5 percent, with a midpoint of 10.3 percent. Accordingly, the current CET1 capital ratio of U.S. banks, as measured using existing RWA calculation methodologies (*i.e.*, 12.8 percent), falls well within the range of optimal capital ratios.

In summary, current bank capital levels are above the midpoint of the range of optimal estimates cited in the proposal and are close to the upper end of recent academic estimates. Therefore, the partial justification given by the agencies for substantially revising and increasing capital requirements for large

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<sup>23</sup> See Francisco Covas and Bill Nelson, *U.S. Bank Capital Levels: Aligning With or Exceeding Midpoint Estimates of Optimal*, Bank Policy Institute (Sept. 18, 2023), available at <https://bpi.com/u-s-bank-capital-levels-aligning-with-or-exceeding-midpoint-estimates-of-optimal/>, and attached as Appendix 7.

<sup>24</sup> See Laurent Clerc et al., *Capital regulation in a macroeconomic model with three layers of default*, 11 Int'l J. Cent. Banking 9 (July 22, 2015), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2629093](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2629093); Vadim Elenev, Tim Landvoigt and Stijn Van Nieuwerburgh, *A Macroeconomic Model with Financially Constrained Producers and Intermediaries*, Vol. 89 Issue 3 *Econometrica* 1361, 1418 (May 13, 2021), available at <https://doi.org/10.3982/ECTA16438>; Juliane Begenau, *Capital requirements, risk choice, and liquidity provision in a business-cycle model*, Vol. 136 Issue 2 *J. Fin. Econ.* 355, 378 (May 1, 2020), available at <https://doi.org/10.1016/j.jfineco.2019.10.004>; Juliane Begenau and Tim Landvoigt, *Financial Regulation in a Quantitative Model of the Modern Banking System*, Vol. 84 Issue 4 *The Rev. of Econ. Stud.* 1748, 1784 (July 2022), available at <https://doi.org/10.1093/restud/rdab088>.

banks fails to engage meaningfully with the current state of academic research, which tends not to support an increase to existing capital levels.

Furthermore, the proposal does not include an independent or specific assessment of what the optimal level of capital is, which makes it difficult to ascertain exactly how the agencies came to the conclusion that the estimated benefits of the proposal outweigh the estimated costs. This is discussed further below.

**B. The proposal’s analysis of the economic impacts of the proposal excludes nearly half of the increase in RWAs; the agencies must correct this error, conduct a more granular cost-benefit analysis and calibrate the proposed capital framework downward accordingly.**

According to the proposal’s impact analysis, the average loan would see a cost increase of a mere three basis points. Therefore, according to the agencies’ assessment, the proposal’s impact on borrowing costs would be negligible, and its benefits for financial stability would outweigh the costs.

The agencies have estimated the effect of the proposal on the lending and trading activities of covered banks by allocating the share of the additional RWAs across all lending and trading activities. The proposal includes changes to the calculation of capital requirements for four risk stripes: credit risk, market risk, operational risk and CVA risk. Credit risk and a portion of operational risk were allocated to lending activities, while market risk, CVA risk and a portion of operational risk were assigned to trading activities.

Although the agencies’ analysis is not fully transparent, we were able to estimate how much of the proposed operational risk charge is allocated to lending activities and how much to trading activities in the agencies’ analysis. The proposal states: “The agencies estimate risk-weighted associated with lending activities would increase by \$380 billion.”<sup>25</sup>

Since the agencies have estimated a \$400 billion decline in RWAs for credit risk, we can implicitly estimate that the lending portion of operational risk is \$780 billion. The \$380 billion increase in RWAs represents a 3.5 percent rise, or a 0.3 percent increase in required capital. If we assume that the cost of equity is 10 percentage points higher than the cost of debt, this leads to a three basis point increase in lending costs, consistent with the proposal’s estimate. Therefore, we believe this is the analysis reflected in the proposal.

With respect to the impact of the proposal on trading activity, the proposal states: “...the agencies estimate that the increase in RWA associated with trading activity (market risk RWA, CVA risk RWA and attributable operational risk RWA) would be around \$880 billion for large holding companies.”<sup>26</sup>

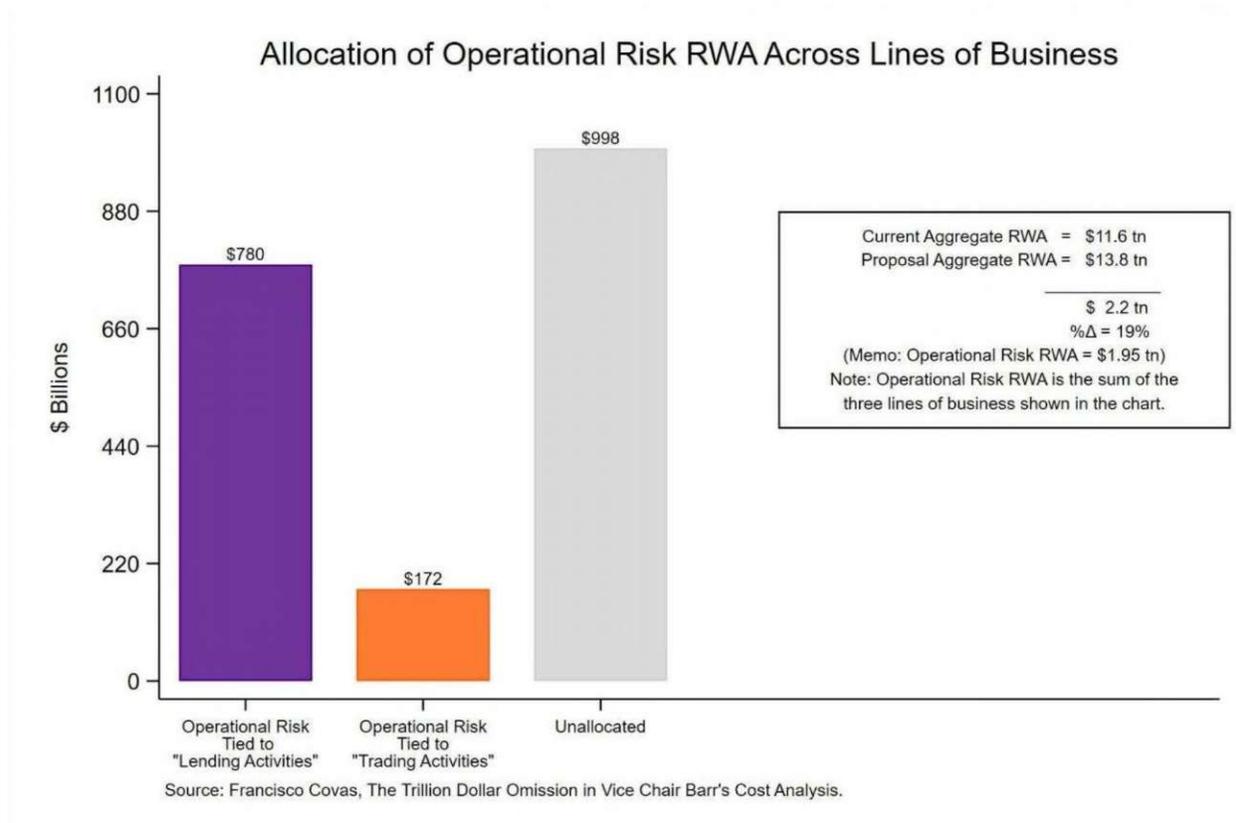
Applying a similar approach to trading as to lending, we can implicitly estimate that the trading activity portion of operational risk is \$172 billion. The results are summarized in Figure 1.

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<sup>25</sup> 88 Fed. Reg. at 64,169.

<sup>26</sup> *Id.* at 64,170.

Figure 1



As the figure above demonstrates, while the agencies estimate a \$1,950 billion increase in RWAs due to the proposed operational risk charge, they have omitted approximately a \$1 trillion increase in RWAs in their economic impact analysis by allocating it to neither lending nor trading activities.<sup>27</sup> About \$1 trillion of the \$2.2 trillion increase in RWAs attributed to operational risk has not been allocated and is excluded from the agencies' estimation of the effects on lending and trading due to the proposed rule. Nor is the economic impact of this \$1 trillion considered elsewhere in the agencies' cost-benefit analysis. This omitted amount, which the agencies implicitly associate with fee income related to other services provided by large banks, represents nearly half of the estimated increase in RWAs. Therefore, its significance is substantial, and its omission results in a meaningful underestimation of the overall economic impact of the proposal.

Given the complexity of the capital proposal, an accurate evaluation of its impact on lending and trading activities requires a careful, comprehensive examination of each component of the proposal and its effects on each of the various lines of business of banks. A survey of BPI and ABA members, discussed in further detail in Appendix 1, demonstrates that banks uniformly expect that the proposal would decrease the amount of credit they can provide, decrease the number and/or variety of customers they can serve and increase their customers' cost of credit, but banks' expectations with respect to different business lines vary considerably. The second-order, and therefore total economic, effects of any changes to capital

<sup>27</sup> See Francisco Covas, *The Trillion Dollar Omission in Vice Chair Barr's Cost Analysis*, Bank Policy Institute (Oct. 12, 2023), available at <https://bpi.com/the-trillion-dollar-omission-in-vice-chair-barrs-cost-analysis/>, and attached as Appendix 8.

requirements will depend on the way in which specific business lines are affected, but the proposal does not explore this dynamic in any meaningful way.

First, the agencies' estimate must consider the lending activity share of the missing \$1 trillion in the services component of the operational risk capital charge calculation. Second, the overall impact assessment needs to consider RWA effects on banks' trading and other financial intermediation activities. Third, the economic impact analysis must consider the business practice of banks, where capital is specifically allocated to different business lines. If a bank's return on equity for a particular business line fails to exceed its cost of capital, considering all changes to capital requirements, the bank may either pass the higher funding cost to borrowers or reduce the size of the business line. This will result in the bank redirecting capital to other business lines or returning it to its shareholders.

BPI analysis, based on publicly available data, suggests that approximately one-third of the RWAs generated from the operational risk's services component is related to lending activity.<sup>28</sup> That includes credit card revenues, lease revenues and loan commitment fees. The other two-thirds applies to trading activities and non-banking services, such as asset management, the underwriting of securities, fees and commissions from securities brokerage and fiduciary activities. The large capital charge associated with the services component also discourages diversification by banks from net interest income. Ultimately, the higher capital charge would still affect consumers because they would bear the increased costs of financial intermediation services.

Within the services component there is notable variation in the proportion of banking and non-banking services driven by differences in banks' business models. For example, lending is most impacted in banks where the lending share of the services component is nearly 100 percent, such as those specializing in credit card and auto lending. In the case of other banks that specialize in asset management, payments and custody services, customers would also feel the impact of the proposal driven by the increase in banks' cost of providing those services.

Unfortunately, the available public data provides only a rudimentary method for categorizing fee income across business lines. Therefore, we recommend that the agencies use information from the Federal Reserve's quarterly FR Y-14 regulatory reports to assess the impact of the RWA generated from the services component on lending activity, trading and other non-banking services, and thereby more accurately assess the overall impact of the proposal on those activities. The FR Y-14 data collection gathers data on noninterest income by line of business and would allow the agencies to allocate the \$1 trillion of RWA in the services component to the different business lines, such as mortgages, credit cards, small business lending, commercial lending, asset management, investment banking, custody services and sales and trading, among others.

Performing revised economic analysis that addresses the gaps and deficiencies in the proposal's current analysis will show a significant increase in the estimated costs of the proposal and that it would result in excessive capitalization of many bank activities. Not only would this over-capitalization fail to achieve a clear benefit that would outweigh the associated costs, but it would actually discourage banks from diversifying from lending activities generating net interest income. Moreover, it would create heightened financial stability risks by promoting the further migration of financial activities outside of the

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<sup>28</sup> See Francisco Covas, Paul Calem, Laura Suhr Plassman and Benjamin Gross, *A Better Way to Conduct the Economic Impact of the Basel Proposal*, Bank Policy Institute (Jan. 9, 2024), available at <https://bpi.com/a-better-way-to-assess-the-economic-impact-of-the-basel-proposal/>, and attached as Appendix 9.

banking system to non-bank financial intermediaries<sup>29</sup> that have proven less willing to maintain access to credit in periods of market stress.<sup>30</sup> In addition, because higher capital requirements would make it more expensive – and, in some cases, impracticable – for banks to provide liquidity during periods of economic and financial market stress, the proposal would make it more likely for the Federal Reserve to intervene as a “market-maker of last resort.”<sup>31</sup>

Maintaining an appropriate balance between costs and benefits of the proposal will therefore require many adjustments to achieve significant downward adjustment of its aggregate impact. The

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<sup>29</sup> See, e.g., Sayee Srinivasan and Jeff Huther, *The Basel III endgame proposal: Yet another gift to private credit funds*, ABA Banking Journal (Nov. 3, 2023) available at <https://bankingjournal.aba.com/2023/11/the-basel-iii-endgame-proposal-yet-another-gift-to-private-credit-funds/>, and attached as Appendix 10 (“One of the consequences will be a further shift of lending to unregulated firms that are free from oversight and capital requirements, increasing the risk of financial instability.”); see also Bill Dudley, “Bigger Financial Cushions Won’t Solve Banks’ Woes,” Bloomberg (Sept. 11, 2023, 6:00 AM), available at <https://www.bloomberg.com/opinion/articles/2023-09-11/the-fed-s-bank-capital-proposal-isn-t-the-right-answer> (“...rising costs will inevitably make banks less competitive relative to non-bank institutions such as private credit firms and alternative mortgage lenders. This should be cause for concern because the latter face much less regulatory oversight and often no capital requirements at all. In trying to strengthen banks, the U.S. could end up with a much more fragile financial system.”); see also A Holistic Review of Regulators: Regulatory Overreach and Economic Consequences: Hearing Before the H. Subcomm. on Fin. Institutions and Monetary Policy of the Comm. on Fin. Servs., 118th Cong. (Sept. 19, 2023), available at <https://docs.house.gov/meetings/BA/BA20/20230919/116342/HHRG-118-BA20-Wstate-PetrouK-20230919.pdf> (testimony of Karen Petrou) (“...the raft of new, bank-centric capital and resolution proposals and of rules still to come has not been constructed with the best possible or even a good, credible effort to anticipate cumulative macroeconomic and systemic consequences. As a result, perverse effects are already all too evident. These perverse consequences will quickly and significantly impair financial stability and sustained, shared growth, as the discussion of key proposals provided below will make all too clear.”).

<sup>30</sup> See Fleckenstein, Q., et al., *Nonbank Lending and Credit Cyclicalities*, NYU Stern School of Business (Dec. 23, 2023) available at <https://ssrn.com/abstract=3629232> (finding that non-banks were responsible for the majority of the decline in lending during the Global Financial Crisis); see also Aldasoro, Iñaki, Sebastian Doerr and Haonan Zhou, *Non-Bank Lending during Crises*, BIS Working Papers No. 1074 (Feb. 16, 2023), available at <https://www.bis.org/publ/work1074.htm> (“We find that non-banks cut their syndicated credit by significantly more than banks during crises, even after accounting for time-varying lender and borrower characteristics.”); Ben-David, Itzhak, Mark Johnson, and René Stulz, *Why Did Small Business FinTech Lending Dry Up During the COVID-19 Crisis?*, Nat’l Bureau of Econ. Rsch. Working Paper No. 29205 (Sept. 2021), available at <https://www.nber.org/papers/w29205>. For a discussion regarding the role of nonbank mortgage lenders and servicers in particular, see Kim, You Suk, et al., “Mapping the boom in nonbank mortgage lending – and understanding the risks,” Brookings Institution Commentary (Sept. 10, 2018), available at <https://www.brookings.edu/articles/mapping-the-boom-in-nonbank-mortgage-lending-and-understanding-the-risks/>; see also Kim, You Suk, et al., “Liquidity Crises in the Mortgage Market,” Brookings Papers on Econ. Act. 347 – 428 (Mar. 8, 2018), available at <https://www.brookings.edu/articles/liquidity-crises-in-the-mortgage-market/>.

<sup>31</sup> See generally Board of Governors of the Federal Reserve, “Federal Reserve announces extensive new measures to support the economy,” (Mar. 23, 2020), available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200323b.htm>; see also Gara Afonso, Marco Cipriani, and Gabriele La Spada, *Banks’ Balance-Sheet Costs, Monetary Policy, and the ON RRP*, Federal Reserve Bank of New York (Dec. 2022), available at [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr1041.pdf](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr1041.pdf).

remainder of this letter outlines a variety of such possible adjustments.

**III. Sufficiently reducing the over-calibration embedded in the proposal requires fundamental structural and conceptual changes to the capital framework.**

**A. The agencies should rationalize the overall structure of the proposal to increase risk-sensitivity and eliminate unjustifiable surcharges.**

A significant portion of the over-calibration of the proposal stems from unsupported structural elements of the U.S. capital framework, specifically, the interaction between the proposal’s “dual-stack”<sup>32</sup> approach and its application of all capital buffer requirements to both stacks. This over-calibration is further aggravated by the way in which the proposal would interact with existing and proposed total loss-absorbing capacity (“TLAC”) and long-term debt (“LTD”) requirements, which the proposal does not meaningfully consider.

The proposal would retain a dual-stack approach in the U.S. capital framework and expand the applicability of the approach to all banks with total assets of \$100 billion or more.<sup>33</sup> The proposal suggests this dual-stack approach is intended to “ensure that large [banks] would not have lower capital requirements than smaller, less complex [banks].”<sup>34</sup> However, the proposal fails to address the ways in which this approach is not sufficiently risk-sensitive – a key objective of the Basel framework<sup>35</sup> – and is unjustifiably designed and calibrated to produce higher capital requirements compared to the international standard.<sup>36</sup>

With respect to risk-sensitivity, the proposal asserts that the Expanded Risk-Based Approach “would be more risk-sensitive than the [Standardized Approach] by incorporating more credit-risk drivers (for example, borrower and loan characteristics) and explicitly differentiating between more types of risk (for example, operational risk, CVA risk)” and, as a result, would “better account for key risks faced by large

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<sup>32</sup> “Dual-stack” refers to the requirement that banks calculate their capital ratios using both the Standardized Approach and the Expanded Risk-Based Approach, with the lower of the two being the binding capital requirement.

<sup>33</sup> Banks with less than \$100 billion in total assets would calculate their risk-based capital ratios using only the Standardized Approach (inclusive of market RWAs under the new market risk capital rule, if applicable).

<sup>34</sup> 88 Fed. Reg. at 64,030.

<sup>35</sup> See, e.g., Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms*, (Dec. 7, 2017), available at <https://www.bis.org/bcbs/publ/d424.pdf> (noting that the revisions aim to promote credibility in the calculation of RWAs by “enhancing the robustness and risk-sensitivity of the standardised approaches for credit risk and operational risk”).

<sup>36</sup> See, e.g., Statement by Travis Hill, Vice Chairman, FDIC, on the proposal to Revise the Regulatory Capital Requirements for Large Banks (July 27, 2023), available at <https://www.fdic.gov/news/speeches/2023/spjul2723b.html> (“... a number of items are gold-plated from the Basel standard, including: within the credit risk framework, the risk weights for residential mortgages, retail exposures, exposures to banks and credit unions, and exposures to small businesses; within the operational risk framework, the floor for the ILM; and within the market risk framework, the requirement that banks use the standardized approach, rather than a modeled approach, for default risk charges. The U.S. is also declining to make several modifications that European jurisdictions have proposed, each of which further reinforces the relative conservatism of the U.S. approach.”).

banks.”<sup>37</sup> Yet, the proposal does not sufficiently explain why major components of the Expanded Risk-Based Approach would depart from the principle of increasing risk-sensitivity. For example, the proposal would add 20 percentage points to the Basel Committee’s risk weights for each loan-to-value (“LTV”) category of residential real estate exposures,<sup>38</sup> which would impose capital requirements higher than necessary to protect against the loss history of the financial crisis<sup>39</sup> and increase capital requirements for residential mortgages with higher LTV ratios, risking significant increases in cost and the reduced availability of credit for many first-time homebuyers and LMI households. More broadly, rather than proposing that banks with total assets of \$100 billion or more calculate their risk-based capital ratios using only the Expanded Risk-Based Approach – or that all banks, including those with less than \$100 billion in total assets, have the option to calculate their risk-based capital ratios using the Expanded Risk-Based Approach – the agencies propose to retain a dual-stack approach, which calls into question the putative rationale of greater risk-sensitivity and alignment to exposures (*i.e.*, if the agencies believed the Expanded Risk-Based Approach was uniformly more risk-sensitive than the Standardized Approach, it would logically follow that they would implement the proposal in a manner that would use only the Expanded Risk-Based Approach to calculate capital requirements for large banks – which are the focus of the proposal – and would permit the use of the Expanded Risk-Based Approach by all other banks).<sup>40</sup> The agencies’ sole justification for requiring banks with more than \$100 billion in total assets to calculate RWAs using both the Expanded Risk-Based Approach and the Standardized Approach is that this approach would “mitigate[] potential competitive benefits for large banks” by requiring that they maintain capital levels “at least as high” as banks with less than \$100 billion in total assets.<sup>41</sup>

With respect to structural surcharges, the proposal would apply all buffer requirements – including the SCB – regardless of whether the Expanded Risk-Based Approach or the Standardized Approach produces the lower capital ratio.<sup>42</sup> This aspect of the proposal diverges from the existing dual-stack approach, under which, for banks subject to an Advanced Approaches capital conservation buffer requirement (*i.e.*, Category I and II banks), a static 2.5 percent capital conservation buffer requirement applies instead of the firm-specific SCB.<sup>43</sup> Because the Expanded Risk-Based Approach would almost

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<sup>37</sup> 88 Fed. Reg. at 64,030.

<sup>38</sup> Compare 88 Fed. Reg. at 64,048 (proposing risk weights of 40 percent, 45 percent, 50 percent, 60 percent, 70 percent and 90 percent across categories of residential real estate loans based on LTV ratios), with Basel Committee on Banking Supervision, *Calculation of RWA for credit risk*, 24 (Dec. 8, 2022), available at [https://www.bis.org/basel\\_framework/chapter/CRE/20.htm?inforce=20230101&published=20221208](https://www.bis.org/basel_framework/chapter/CRE/20.htm?inforce=20230101&published=20221208) (setting risk weights of 20 percent, 25 percent, 30 percent, 40 percent, 50 percent and 70 percent across categories of residential real estate loans with the same LTV ratios).

<sup>39</sup> See Goodman and Zhu, *supra* note 13.

<sup>40</sup> In addition to this incongruity, the agencies’ assertion that the proposal would “reduce complexity and operational costs” appears to be offered without any corresponding analysis or support. 88 Fed. Reg. at 64,030. Independent analyses have observed that the proposed requirements, including the proposed calculation of RWAs under multiple approaches, would “impose significant operational complexity.” See PwC, *Basel III endgame: Complete regulatory capital overhaul*, (Aug. 2023), available at <https://www.pwc.com/us/en/industries/financial-services/library/our-take-special-edition-basel-iii-endgame.pdf>.

<sup>41</sup> 88 Fed. Reg. at 64,170.

<sup>42</sup> See 88 Fed. Reg. at 64,031.

<sup>43</sup> See *id.* at 64,034.

always produce the binding capital requirement for covered banks,<sup>44</sup> and because the application of the SCB to the Expanded Risk-Based Approach would effectively require covered banks to over-capitalize for operational risk and certain market risks,<sup>45</sup> this structural aspect of the proposed framework would result in substantially higher capital requirements.<sup>46</sup>

The agencies must correct the structural deficiencies embedded in the proposal by addressing (i) the interaction between the proposal and TLAC and LTD requirements (existing and proposed), (ii) the calibration of the GSIB surcharge, including its interaction with elevated RWAs under the Expanded Risk-Based Approach and (iii) the application and structure of the SCB requirement, as discussed in Section III.B below.

1. The interrelationship between the proposal and the current, and proposed, LTD requirements requires a holistic evaluation before adoption.

The proposal would increase risk-based TLAC and LTD applicable to U.S. GSIBs and the IHCs of non-U.S. GSIBs, as well as the proposed LTD requirements applicable to Category II through IV banks and certain of their insured depository institution subsidiaries. The proposal would broadly increase RWAs, and the increase in RWAs would increase current and proposed TLAC and LTD requirements, among other things. The agencies acknowledged that they did not consider the potential effects of the proposal in their impact analysis on the proposed LTD requirements applicable to Category II through IV banks and certain of their insured depository institution subsidiaries, but recognized that (i) if adopted, the proposal would increase RWAs for banks covered by the proposal, and (ii) the RWA increases would “lead mechanically to increased requirements for LTD under the LTD proposal.”<sup>47</sup> Beyond this recognition, however, the agencies have not analyzed the interrelationship between the two proposals in terms of overall costs, whether and how either proposal should factor into the design or calibration of the other, or otherwise. Nor have the agencies addressed the fact that the LTD proposal would require a significantly higher volume of LTD issuance, which could strain market capacity and increase costs for banks and, by extension, their customers, including consumers and end users. There is also no indication that the agencies have considered whether there is any evidence indicating that overall levels of loss-absorbing capacity should increase for banks currently subject to TLAC/LTD requirements. Finally, it is important to note that studies of optimal levels of capital have not considered the impact of TLAC or LTD, and the fact that the proposal would significantly increase RWAs – and, thereby, TLAC and LTD requirements – only exacerbates that shortcoming.

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<sup>44</sup> See *id.* at 64,168 (estimating that the Expanded Risk-Based Approach would become the “binding risk-based approach for most large banks”); see also Guowei Zhang, Peter Ryan and Carter McDowell, “Understanding the Proposed Changes to the U.S. Capital Framework,” SIFMA (Aug. 28, 2023), available at <https://www.sifma.org/resources/news/understanding-the-proposed-changes-to-the-us-capital-framework/>.

<sup>45</sup> See *infra* Section III.B.1 and Section III.B.2.

<sup>46</sup> The agencies estimate that the proposal would increase binding CET1 capital requirements by 19 percent for holding companies in Categories I and II, six percent for domestic holding companies in Categories III and IV, and 14 percent for intermediate holding companies of foreign banks in Categories III and IV.

<sup>47</sup> Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions, 88 Fed. Reg. 64,524, 64,551 (Sept. 19, 2023).

2. The interrelationship between the proposal and GSIB surcharge requires a holistic evaluation before adoption.

The proposal would have a multiplier effect on capital requirements for GSIBs given that increases in RWAs correspond to higher capital requirements to satisfy GSIB surcharges. The Federal Reserve should address the over-calibration of the capital requirements resulting from the application of the GSIB surcharge to RWAs calculated under the Expanded Risk-Based Approach by recalibrating the GSIB surcharge to reflect (i) economic growth since the framework was finalized in 2015<sup>48</sup> and (ii) the broad increase in capital requirements as a result of the Expanded Risk-Based Approach. We also support the recommendations from the Financial Services Forum regarding changes to the calibration of the GSIB surcharge.

**B. The proposal wholly fails to recognize and reconcile how its requirements are excessive when accounting for stress capital requirements and thereby significantly overstates risk.**

In addition to the multiplier effect on capital requirements for GSIBs, the proposal would result in the excessively high calibration of capital requirements for operational risk and market risk across stress capital requirements and the new standardized Expanded Risk-Based Approach.

Although Vice Chair for Supervision Barr has attempted to distinguish between minimum capital requirements and capital buffers derived from the stress tests,<sup>49</sup> this argument fails for three reasons. First, it does not reflect that capital requirements are set through two aspects of the capital framework: (i) the calculation of RWAs and (ii) the determination of numerical ratio requirements, including buffer requirements; *i.e.*, RWAs determine the dollar amount of capital necessary to satisfy both minimum requirements and buffer requirements. Second, it does not reflect that, for all practical purposes, a buffer requirement is as binding as a minimum requirement in light of the severe market, reputational, supervisory and regulatory requirements of breaching a buffer. Third, there are design similarities between the underlying methodologies for calculating stress capital requirements and RWAs under the

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<sup>48</sup> See Sean Campbell, Francisco Covas, and Guowei Zhang, *The Federal Reserve Should Revise the U.S. GSIB Surcharge Methodology to Reflect Real Risks and Support the Economy*, Bank Policy Institute (Oct. 11, 2023), available at <https://bpi.com/wp-content/uploads/2023/10/The-Federal-Reserve-Should-Revise-the-U.S.-GSIB-Surcharge-Methodology-to-Reflect-Real-Risks-and-Support-the-Economy.pdf>, and attached as Appendix 11.

<sup>49</sup> See, e.g., Michael S. Barr, "Holistic Capital Review," (July 10, 2023), available at <https://www.federalreserve.gov/newsevents/speech/barr20230710a.htm> ("Banks have raised concerns that the changes to the risk-based capital framework I described earlier, combined with the stress test, result in a 'double counting' of risk that is already captured in the minimum requirements. Conceptually, this shouldn't be the case, as the changes in the risk-based capital requirements affect the way that minimum capital requirements are calculated, and the stress test is used to calculate the buffer."); see also Michael S. Barr, "Multiple Scenarios in Stress Testing," (Oct. 19, 2023), available at <https://www.federalreserve.gov/newsevents/speech/barr20231019a.htm> ("Some people have raised this idea of whether risk-based capital requirements interact with the stress test in a way that people say double counts the risk. I would just say, conceptually, I don't think that's the right way of thinking about it. Conceptually, the risk weights that we use in our static risk-weight approach are designed to assess the minimum capital requirements for a firm, and we use the stress test process to figure out what the buffer above that minimum should be.").

Expanded Risk-Based Approach.

Under the Expanded Risk-Based Approach, RWAs would include, among other things, operational risk, CVA risk and market risk, the latest using the new market risk capital rule based on the Basel Committee’s Fundamental Review of the Trading Book (“FRTB”).<sup>50</sup> Because the Dodd-Frank Act Stress Tests (“DFAST”) are designed to capture similar risks,<sup>51</sup> the application of the SCB to RWAs under the Expanded Risk-Based Approach would introduce excessive capital requirements for operational risk, certain market risks and CVA risk. In particular, operational risk and market risk relating to tail events and illiquidity would be capitalized through both the SCB and the Expanded Risk-Based Approach.

In his statement accompanying his vote against the proposal, Governor Waller observed this excessive calibration, stating: “Operational risk expense projections in the stress test have been just under \$200 billion over the past few years. The impact analysis in the proposal suggests the enhanced standardized capital stack will have operational RWAs that are nearly \$2 trillion higher than in the current standardized stack, which could lead to a more than doubling of the operational risk capital required relative to just the stress test-based requirement . . . there is no discussion on why operational risk capital needs to be an additional charge as opposed to just using the existing capital stack to absorb operational losses.”<sup>52</sup>

Although the agencies argue that applying the SCB to banks’ risk-based capital ratios resulting from both the Expanded Risk-Based Approach and the Standardized Approach would “ensure that the [SCB] requirement contributes to the robustness and risk-sensitivity of the risk-based capital requirements of banks,”<sup>53</sup> they do not address the fact that applying the SCB to the revised methods for calculating RWAs would effectively increase required capital for these risks. We appreciate Vice Chair for Supervision Barr’s commitment to seek public comment on “whether interaction [of the proposal] with the stress test results in an inappropriate treatment.”<sup>54</sup> To respond succinctly, it unquestionably does.

To address the excessive calibration of capital requirements and rationalize the capital framework, the Federal Reserve should:

- (i) not apply the SCB to capital requirements under the Expanded Risk-Based Approach;
- (ii) if the SCB is applied to capital requirements calculated under the Expanded Risk-Based Approach:
  - Remove operational risk losses in the stress tests (from peak to trough) from the business indicator component (“BIC”) or exclude operational risk losses from the SCB;
  - Exclude CVA losses from the SCB; and

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<sup>50</sup> The Standardized Approach would also include market RWAs using the FRTB-based market risk capital rule.

<sup>51</sup> See 12 C.F.R. 252, Appendix A.

<sup>52</sup> Board of Governors of the Federal Reserve, “Statement by Governor Christopher J. Waller,” (July 27, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm>.

<sup>53</sup> 88 Fed. Reg. at 64,034 – 35.

<sup>54</sup> Barr, Holistic Capital Review, *supra* note 49.

- Fundamentally recalibrate operational risk RWAs, as described in more detail in Section V;

(iii) recalibrate the GMS by modifying the assumption of no liquidity over an extended period of time to one of limited liquidity;

(iv) recalibrate the GMS by removing private equity from the GMS and instead forecasting private equity losses as part of the macroeconomic scenario; and

(v) recalibrate the assumptions related to loss given default in the stress test loss projections.

These changes would mitigate some – but would not solve all – of the issues relating to structural surcharges and over-calibration. Without these changes, however, banks subject to the proposal would be required to over-capitalize these risks, which could have significant unintended consequences.<sup>55</sup>

1. The Federal Reserve should address the over-calibration of operational risk capital requirements due to the interplay between the SCB and the Expanded Risk-Based Approach.

Supervisory stress testing models were designed and calibrated based on the existing Standardized Approach. With the application of stress capital requirements to the Expanded Risk-Based Approach, capital requirements for operational risk would more than double because, unlike the Standardized Approach, the Expanded Risk-Based Approach contains an explicit capital charge for operational risk.<sup>56</sup> The dramatic increase implies that banks are, today, severely undercapitalized with respect to operational risk capital, but the agencies have provided no evidence to suggest that that is the case. To the contrary, officials from the Federal Reserve – including Vice Chair for Supervision Barr – and other leading policymakers have recognized the strong capital levels across banks subject to U.S. capital rules.<sup>57</sup>

BPI’s top-down models indicate that the inclusion of operational risk losses in the 2022 DFAST (*i.e.*, the last stress test conducted with all covered banks participating) would result in a 118 basis point decline in the CET1 capital ratios under stress across the 32 participating banks. This is equivalent to a capital requirement for operational risk of \$138 billion. The Expanded Risk-Based Approach would require banks

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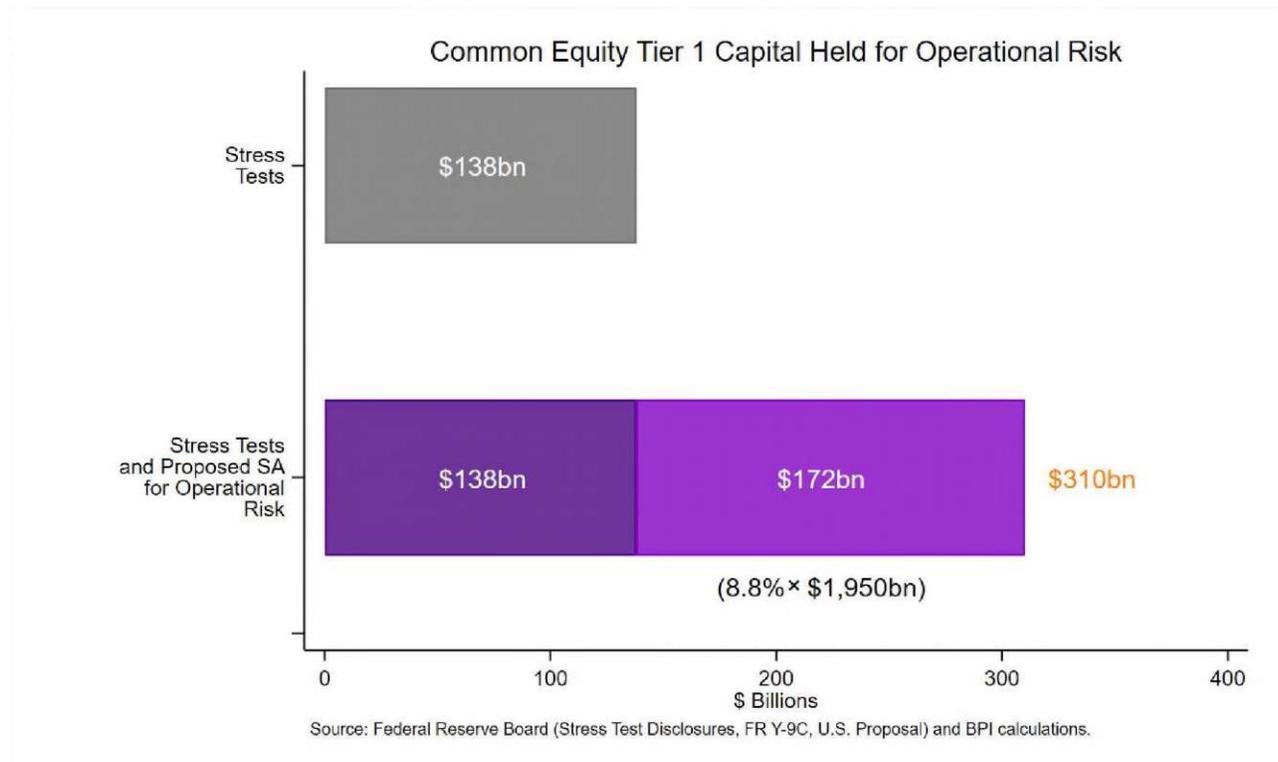
<sup>55</sup> See Barr, *supra* note 49.

<sup>56</sup> See Barr, *supra* note 49.

<sup>57</sup> See, e.g., Michael S. Barr, “Why Bank Capital Matters,” Board of Governors of the Federal Reserve (Dec. 1, 2022) (“We have strong capital levels today, and generally higher bank capital requirements in the United States after the Dodd-Frank Act have corresponded with healthy economic growth and have supported the competitiveness of U.S. firms in the global economy . . . We’re starting from a good place because capital today is strong.”), available at <https://www.federalreserve.gov/newsevents/speech/barr20221201a.htm>; Board of Governors of the Federal Reserve, “Statement by Chair Jerome H. Powell,” (July 27, 2023) (“The U.S. banking system is sound and resilient, with strong levels of capital and liquidity.”), available at <https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20230727.htm>; CNBC News Releases, “CNBC Transcript: United States Treasury Secretary Janet Yellen Speaks with CNBC’s Sara Eisen on ‘Closing Bell: Overtime’ Today,” CNBC (May 8, 2023, 5:05 PM) (quoting Treasury Secretary Yellen as saying there is “adequate capital and liquidity in America’s banking system”), available at <https://www.cnbc.com/2023/05/08/cnbc-transcript-united-states-treasury-secretary-janet-yellen-speaks-with-cnbc-sara-eisen-on-closing-bell-overtime-today.html>.

to hold an additional \$172 billion in CET1 capital.<sup>58</sup> If the Federal Reserve adjusted the ILM under DFAST to result in an increase in RWAs under stress, capital requirements for operational risk would be even more excessive. However, given the flat balance sheet/RWA assumption in the Federal Reserve’s Stress Testing Policy Statement,<sup>59</sup> we do not believe the Federal Reserve would, under its current policy, be permitted to use the ILM to increase RWAs – and, thereby, operational risk capital – under stress. We urge the Federal Reserve to maintain this aspect of the Stress Testing Policy Statement to avoid exacerbating the clear problem of excessive calibration.

Figure 2

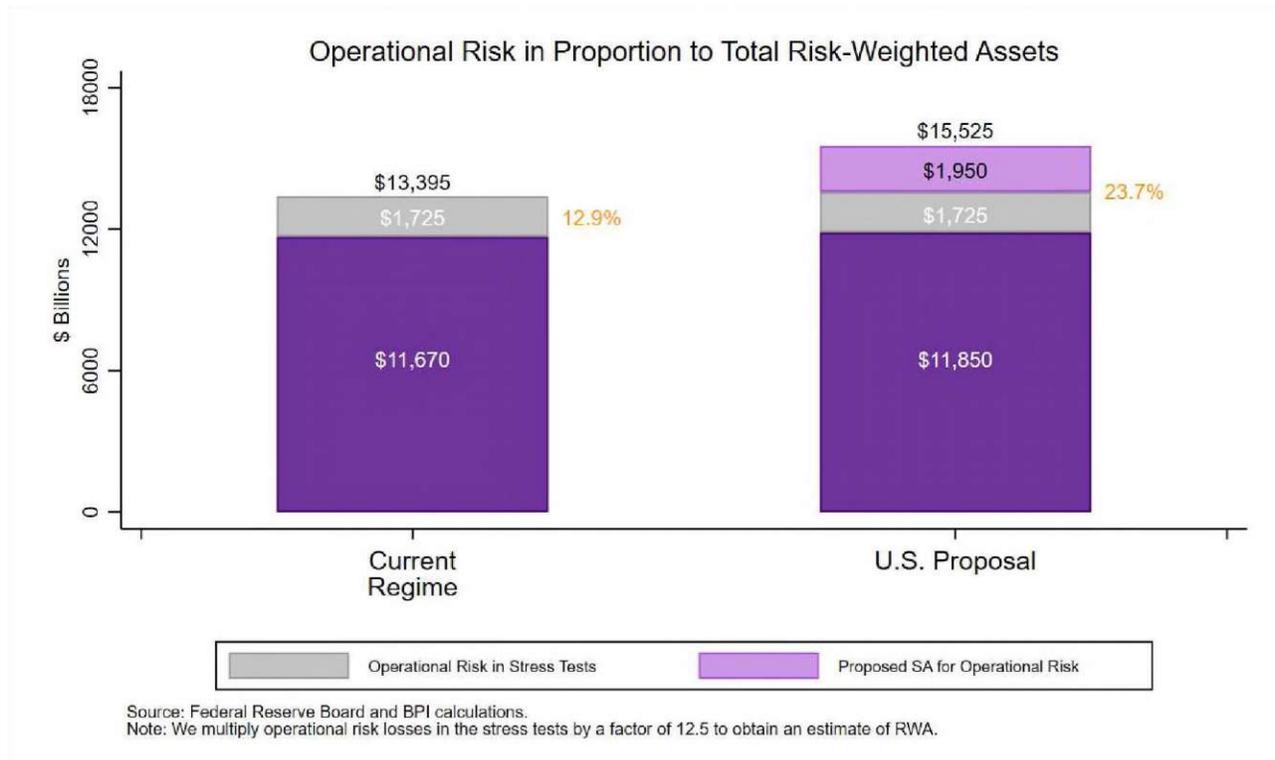


For the purposes of calculating operational risk RWAs, banks are effectively required to set aside \$1,725 billion from the stress tests and another \$1,950 billion resulting from the implementation of the proposal (Figure 3). This corresponds to approximately 23.7 percent of total RWAs allocated for operational risk under the U.S. proposal.

<sup>58</sup> This figure is derived by multiplying \$1.95 trillion (*i.e.*, the estimated amount of operational RWAs added by the Expanded Risk-Based Approach) by 8.8 percent (*i.e.*, the weighted average of seven percent CET1 capital requirements plus the GSIB surcharge).

<sup>59</sup> See 12 C.F.R. 252, Appendix B, § 3.4 (“In projecting risk-weighted assets, the Federal Reserve will generally assume that a covered company’s risk-weighted assets remain unchanged over the planning horizon.”). However, RWAs under stress could increase under banks’ company-run stress tests as a result of the ILM.

Figure 3



2. The Federal Reserve should address the excessive calibration of market risk capital requirements.

- a) *The Federal Reserve should remove private equity from the GMS and instead forecast private equity losses as part of the macroeconomic scenario, which the Federal Reserve has stated is more appropriate.*

In addition to substantially reducing the calibration of the GMS, the Federal Reserve should remove private equity from the GMS. Private equity is in the banking book and should not be subjected to a mark-to-market shock developed for the trading book. The Federal Reserve has not established that the GMS is more appropriate for forecasting stress losses related to private equity exposures than using the nine-quarter macroeconomic scenario. The Federal Reserve should develop and disclose a methodology to forecast private equity exposures in the macroeconomic scenario and remove these losses from the GMS.

In addition, the Federal Reserve’s existing treatment of private equity under the stress tests is inconsistent with the way losses are recognized under generally accepted accounting principles (“GAAP”). Under GAAP, banks may elect to measure the value of equity investments that do not have readily determinable values, such as private equity investments, at cost minus impairment, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment of the same issuer.<sup>60</sup>

<sup>60</sup> See Financial Accounting Standards Board, *Investments – Equity Securities (Topic 321), Investments – Equity Method and Joint Ventures (Topic 323), and Derivatives and Hedging (Topic 815)*, (Jan. 2020), available at

As discussed further in Section VI.A, because the proposal would not include a separate risk weight for non-significant equity exposures, certain investment activities would be subject to a 400 percent risk weight – four times the current risk weight for these activities. If the agencies do not implement our recommendations to modify that proposed change, the increase in RWA would justify reducing the shocks under the GMS by at least 40 percent.<sup>61</sup>

- b) *The Federal Reserve should recalibrate the GMS by modifying the assumption of no liquidity over an extended period of time to one of limited liquidity.*

The combination of the FRTB and the inclusion of the GMS as currently calibrated in the SCB would result in a significant over-capitalization of market risk. The GMS grew out of the Supervisory Assessment Program (“SCAP”) in 2009 and was formalized in the Comprehensive Capital Analysis and Review (“CCAR”) in 2011.<sup>62</sup> Introduction of the GMS, which subjects banks’ trading portfolios to stress shocks that might occur during extreme market conditions or a financial crisis, was intended to address the problems with Basel I and ensure that banks were adequately capitalized for market risk while the problems with Basel I were addressed. To resolve these problems, the Basel Committee began work on the FRTB in early 2009.<sup>63</sup> The FRTB was designed to solve the same problem already addressed by the GMS,<sup>64</sup> since it measures market risk under extreme market conditions or in a financial crisis.<sup>65</sup> Both methodologies are designed to capture the risk of long periods of complete market illiquidity. In effect, the inclusion of the GMS in the SCB as currently calibrated is designed to ensure that banks could sustain very large losses caused by profound market illiquidity in an extreme financial crisis and still have sufficient capital to withstand

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<https://fasb.org/Page/ShowPdf?path=ASU+2020-01%2C0.pdf>.

<sup>61</sup> Currently, with a 100 percent risk weight for these investment activities, the average capital rate (excluding the SCB) is 8.8 percent, and the average shock related to private equity is 60 percent, yielding a total rate of 69 percent ( $100 \times 0.088 + 60$ ). Assuming the elimination of non-significant equity exposures, the total rate would be 95.2 percent ( $400 \times 0.088 + 60$ ). Thus, the shock should be reduced by 43 percent to set the total rate back to 68 percent ( $400 \times 0.088 + 34$ ).

<sup>62</sup> See Board of Governors of the Federal Reserve, “Comprehensive Capital Analysis and Review: Objectives and Overview,” (Mar. 18, 2011) (“In addition to the macroeconomic scenario provided by the Federal Reserve to all 19 bank holding companies, the six largest firms were required to estimate potential losses stemming from trading activities and private equity investments using the same severe global market shock scenario that was applied in the SCAP.”), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20110318a1.pdf>.

<sup>63</sup> See Basel Committee on Banking Supervision, *Revisions to the Basel II market risk framework*, (Jan. 16, 2009), available at <https://www.bis.org/publ/bcbs148.htm> (“[T]he Committee will be initiating a longer-term, fundamental review of the risk-based capital framework for trading activities.”).

<sup>64</sup> See Basel Committee on Banking Supervision, *Explanatory note on the minimum capital requirements for market risk*, (Jan. 2019), available at [https://www.bis.org/bcbs/publ/d457\\_note.pdf](https://www.bis.org/bcbs/publ/d457_note.pdf) (addressing the perceived weaknesses in Basel 2.5, including 10-day liquidity horizons, exclusions of tail risks and extensive diversification benefits).

<sup>65</sup> For a more detailed analysis of how the FRTB captures the same risks as the GMS, see Greg Hopper, *How Can The Global Market Shock More Effectively Complement The Fundamental Review of the Trading Book?*, Bank Policy Institute (May 30, 2023), available at <https://bpi.com/how-can-the-global-market-shock-more-effectively-complement-the-fundamental-review-of-the-trading-book/>, and attached as Appendix 12.

additional very large losses produced by profound market illiquidity in another extreme financial crisis.

Since there seem to be no empirical or theoretical reasons for the excessive amount of capital required for market risk and CVA risk, the GMS shocks should be recalibrated to: (i) reduce the excessive amount of capital required between FRTB/CVA and the GMS and (ii) make the GMS calibration based on an empirically grounded and objective methodology rather than subjective assumptions.

To recalibrate the GMS, the Federal Reserve should compare the liquidity assumptions in the FRTB and the GMS to avoid capturing the same risks in both. The FRTB's liquidity assumptions are explicit (although not justified in the proposal): For equities, the period of illiquidity is 10 – 20 days; for investment grade credit, the period of illiquidity is 40 days; for high yield credit, the period of illiquidity is 60 days.<sup>66</sup> For the models-based approach, the FRTB captures financial crisis conditions by requiring asset shocks at the 97.5 percent confidence level, measured by expected shortfall, calibrated using one year of the most volatile market conditions<sup>67</sup> during periods of substantial market illiquidity.<sup>68</sup>

On the other hand, the GMS generally assumes longer illiquidity horizons but is relatively opaque about how it calibrates the risk factor shocks. Initially, the GMS was calibrated using a six-month illiquidity period in both the original SCAP and the 2011 CCAR exercise. Subsequently, the Federal Reserve became more vague, saying that the shocks were initially and generally calibrated to market moves in the second half of 2008.<sup>69</sup> In the three most recent DFAST exercises, it is unclear to what horizon the GMS was calibrated. In the 2023 CCAR/DFAST scenario, the Federal Reserve appears to calibrate to a final value slightly higher than the maximum investment grade credit default swap (“CDS”) spread level in November 2008:

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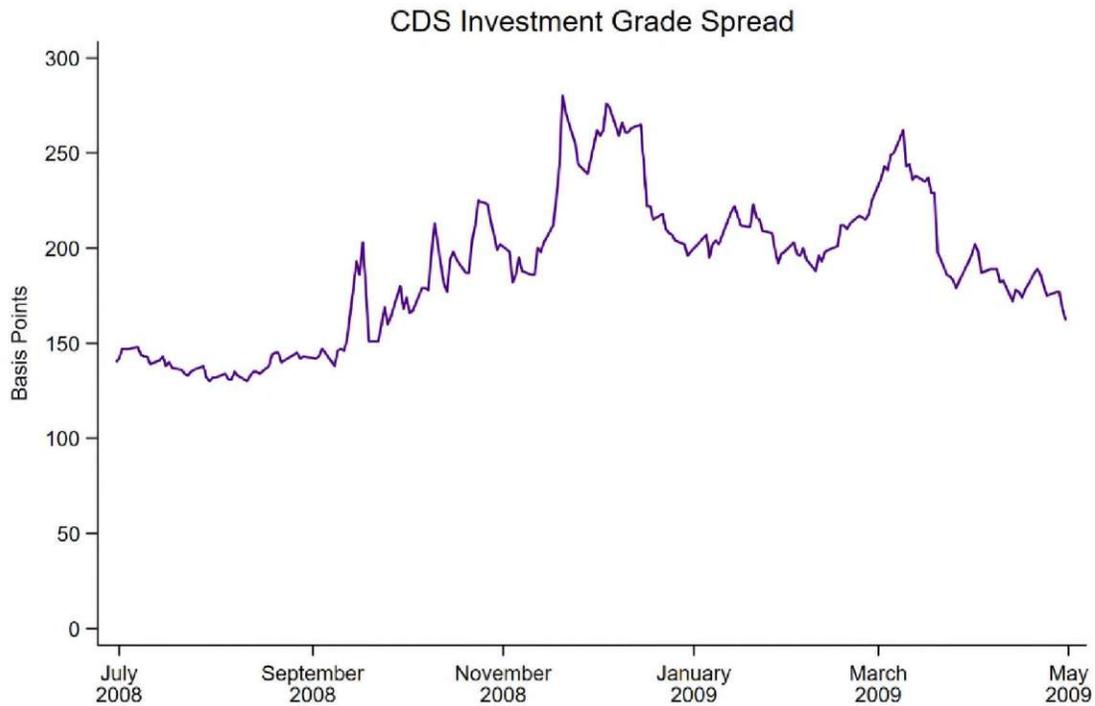
<sup>66</sup> See 88 Fed. Reg. at 64,137 – 38.

<sup>67</sup> See *id.* at 64,135.

<sup>68</sup> Although the standardized approach in the FRTB was not expressly calibrated to a 97.5 confidence level, the calibration of the models-based approach is relevant for the standardized approach because, according to the proposal, “[t]he agencies view the proposed standardized measure for market risk as sufficiently risk sensitive to serve as a credible floor to the models-based measure for market risk.” 88 Fed. Reg. at 64,110.

<sup>69</sup> See 12 C.F.R. 252, Appendix A, § 5.2.3 (“... the market shock component for the severely adverse scenario will incorporate key elements of market developments during the second half of 2008, but will also incorporate observations from other periods or price and rate movements in certain markets that the Board deems to be plausible, though such movements may not have been observed historically. Over time, the Board also expects to rely less on market events of the second half of 2008 and more on hypothetical events or other historical episodes to develop the market shock.”).

Figure 4



In the 2021 DFAST scenario, the GMS investment grade CDS shock was unprecedented. The Federal Reserve has stated that it chooses its calibration horizons of the risk factor shocks to account for “unpredictable liquidity conditions that prevail in times of stress.”<sup>70</sup> However, the choice of six months or any other historical period to account for uncertainty is arbitrary.<sup>71</sup> Moreover, the six months of losses are assumed to happen instantaneously, with no ability of a bank to re-hedge. In other words, this assumption implies that a bank could not exit its equity, Treasury or other security holdings for six months while it accrues losses, and it could not hedge such losses because of market illiquidity. These assumptions do not align with the Federal Reserve’s policy objectives of designing a conservative but plausible scenario.<sup>72</sup> In sum, the FRTB’s liquidity horizons are explicit and based on specified confidence intervals. By contrast, the GMS liquidity horizons are opaque, and appear to be highly subjective.<sup>73</sup>

<sup>70</sup> See, e.g., Board of Governors of the Federal Reserve, “2023 Stress Test Scenarios,” 10 (Feb. 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230209a1.pdf>.

<sup>71</sup> See 12 C.F.R. 252, Appendix A, § 3.2 (“For instance, market shocks that might typically be observed over an extended period (e.g., six months) are assumed to be an instantaneous event which immediately affects the market value of the companies’ trading assets and liabilities.”).

<sup>72</sup> See 12 C.F.R. 252, Appendix A, § 5.2.2.

<sup>73</sup> See Board of Governors of the Federal Reserve, 2023 Stress Test Scenarios, *supra* note 70 (“shocks to risk factors in more-liquid markets, such as those for government securities, foreign exchange, or public equities, are calibrated to shorter horizons (such as three months), while shocks to risk factors in less-liquid markets, such as those for non-agency securitized products or private equities, have longer calibration horizons (such

Although the Federal Reserve has never explained how it designs the GMS shocks, it appears the shocks are designed to target either a spread level or a default probability for spread shocks and a fair-value level for equity shocks. Using that methodology, shocks would be worse if spreads were tighter or equities were overvalued. That methodology could be used if the shock calibration were being subjectively determined, but it is not necessarily consistent with an econometric model. To develop an objective way to compare the FRTB illiquidity assumptions to those of the GMS, we can simulate equity prices and CDS spreads using econometric models starting on the as-of date of the last three GMS exercises.<sup>74</sup> For example, to compute the 99 percent<sup>75</sup> worst equity loss over 20 days for the S&P 500, we would simulate 20-day equity paths using as the starting value the S&P 500 on each of the as-of dates of the last three GMS tests.

**Figure 5**

Simulated S&P 500 Shocks  
Compared to FRTB and GMS

	2023 GMS	2022 GMS	2021 GMS
<b>Days</b>	25	25	25
<b>Shock</b>	-43.2%	-42.6%	-43.2%
<b>Days</b>	20	20	20
<b>Shock</b>	-36.6%	-36.6%	-37.1%
<b>Days</b>	10	10	10
<b>Shock</b>	-25.3%	-24.9%	-23.9%
<b>Actual GMS</b>	-26.3%	-38.3%	-26.0%
<b>FRTB Liquidity Assumption (Days)</b>	10	10	10

The above table shows the simulated equity shocks produced at the 99 percent confidence level at various horizons for the S&P 500. We use 99 percent to maintain comparability with the FRTB, which calibrates estimated shortfall to a 97.5 percent confidence level, equivalent to a 99 percent VaR when returns are normally distributed. For example, using a 20-day horizon, the 99 percent shock was -36.6 percent using the starting value of the 2022 GMS. Thus, if we assumed that the period of illiquidity was 20 days, so that the S&P 500 could not be bought, sold or hedged over that period, then a position that a bank is forced to sit on for 20 trading days would have lost 36.6 percent in value at the 99 percent confidence level. Judging from the vantage point of the simulation, the 2022 GMS of -38.3 percent appears to assume roughly a 20-day period of illiquidity.

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as 12 months)").

<sup>74</sup> For more details on the analysis presented in this section, see Greg Hopper, *Rationalizing the Global Market Shock*, Bank Policy Institute (Oct. 17, 2023), available at <https://bpi.com/rationalizing-the-global-market-shock/>, and attached as Appendix 13.

<sup>75</sup> We use a 99 percent confidence level for the simulations since the 97.5 percent confidence level used for the expected shortfall in the FRTB methodology is equivalent to a 99 percentile VaR when asset returns are normally distributed.

Comparing the simulated shocks to the GMS shocks in general, we can see that over the last three GMS exercises, the U.S. public equity GMS stress seems to be calibrated to between a 10- to 20-day illiquidity horizon at a 99 percent confidence level under stressed market conditions. It is worth noting that the 2023 Stress Test Scenarios issued by the Federal Reserve stated that public equity shocks were calibrated to a three-month liquidation period,<sup>76</sup> but the results suggest the GMS shocks actually assumed a 10-day period of illiquidity in 2023 when stated in FRTB-equivalent terms. Thus, the equity shock in the GMS, at least over the most recent GMS tests, is essentially repeating the FRTB illiquidity assumptions.

The following tables repeat the analysis for investment grade and high yield CDS spread shocks. Comparing the GMS shocks to the simulated CDS shocks, the results suggest strongly that the GMS shocks for investment grade CDS spreads are indeed calibrated to a period of six months or longer when compared to the FRTB. We see the same result for high yield CDS spreads. High yield spread shocks seem to be calibrated to a six-month liquidation period at a 99 percent confidence level under stressed market conditions.<sup>77</sup>

**Figure 6**

Simulated IG CDS Spread Shocks  
Compared to FRTB and GMS

	2023 GMS	2022 GMS	2021 GMS
<b>Days</b>	126	126	126
<b>Shock</b>	187.2%	199.1%	189.7%
<b>Days</b>	90	90	90
<b>Shock</b>	156.5%	146.3%	150.2%
<b>Days</b>	60	60	60
<b>Shock</b>	110.7%	112.5%	105.8%
<b>Days</b>	40	40	40
<b>Shock</b>	83.7%	83.3%	83.1%
<b>Days</b>	20	20	20
<b>Shock</b>	54.5%	53.8%	55.2%
<b>Days</b>	10	10	10
<b>Shock</b>	37.5%	37.8%	37.2%
<b>Actual GMS</b>	177.4%	326.7%	548.2%
<b>FRTB Liquidity Assumption (Days)</b>	40	40	40

<sup>76</sup> See Board of Governors of the Federal Reserve, 2023 Stress Test Scenarios, *supra* note 70.

<sup>77</sup> We recognize that credit and most other spread shocks are defined under the current GMS methodology in basis points. Thus, in percentage terms, IG shocks will always be larger than HY shocks because spreads are tighter for IG, so any given spread increase in basis points will result in a larger percentage shock due to a smaller denominator for IG.

**Figure 7**

Simulated HY CDS Spread Shocks  
Compared to FRTB and GMS

	2023 GMS	2022 GMS	2021 GMS
<b>Days</b>	126	126	126
<b>Shock</b>	204.3%	200.8%	195.2%
<b>Days</b>	90	90	90
<b>Shock</b>	146.1%	142.8%	142.7%
<b>Days</b>	60	60	60
<b>Shock</b>	97.5%	101.1%	97.8%
<b>Days</b>	40	40	40
<b>Shock</b>	70.6%	69.5%	68.5%
<b>Days</b>	20	20	20
<b>Shock</b>	44.0%	42.5%	43.5%
<b>Days</b>	10	10	10
<b>Shock</b>	28.6%	29.0%	29.1%
<b>Actual GMS</b>	80.0%	206.8%	247.8%
<b>FRTB Liquidity Assumption (Days)</b>	60	60	60

It is unclear why there is such a vast discrepancy between the illiquidity assumptions used for equities and CDS in the GMS. It is understandable that credit markets are assumed to be more illiquid than equity markets during a crisis, but the difference in assumptions is notable. When compared to the FRTB, the GMS equity shock repeats the FRTB. However, the GMS credit shocks repeat the FRTB many times over. The GMS shocks could be substantially reduced while maintaining realistic, but conservative, illiquidity assumptions that do not repeat the FRTB.

Finally, if the Federal Reserve declines to modify the GMS along the lines suggested in this letter, it should exclude the impact of GMS-related losses from SCB calculations, including the CVA component. Alternatively, the Federal Reserve could use the GMS like the exploratory market shock (*i.e.*, for informational and supervisory purposes, but not to set buffer requirements).

- c) *The Federal Reserve should either modify the large counterparty default or exclude the impact of LCD-related losses from SCB calculations.*

The Federal Reserve should also modify the large counterparty default (“LCD”) given its overlap with the FRTB and the standardized approach to counterparty credit risk (“SA-CCR”). If the Federal Reserve declines to modify the LCD, it should exclude the impact of LCD-related losses from SCB calculations. At a minimum, the Federal Reserve should align the LCD calibration with standard counterparty credit risk assumptions (*e.g.*, with respect to margining practices).

3. The Federal Reserve should adjust the calibration of the assumptions related to loss given default in the stress test projections to align with banks' own loss experience and risk-mitigating actions taken during stress periods.

The significant increase in RWAs proposed under the Expanded Risk-Based Approach, combined with potential upcoming changes in the Federal Reserve's calculation of the allowance for credit losses ("ACL") in the stress test, would lead to an even greater increase in capital requirements. The Federal Reserve should adjust the calibration of the assumptions related to loss given default in the stress test loss projections to be more in line with banks' own loss experience and risk-mitigating actions taken during stress periods. These adjustments would prevent the potential upcoming changes in the Federal Reserve's allowance calculations from further increasing banks' capital requirements without any change in risk.

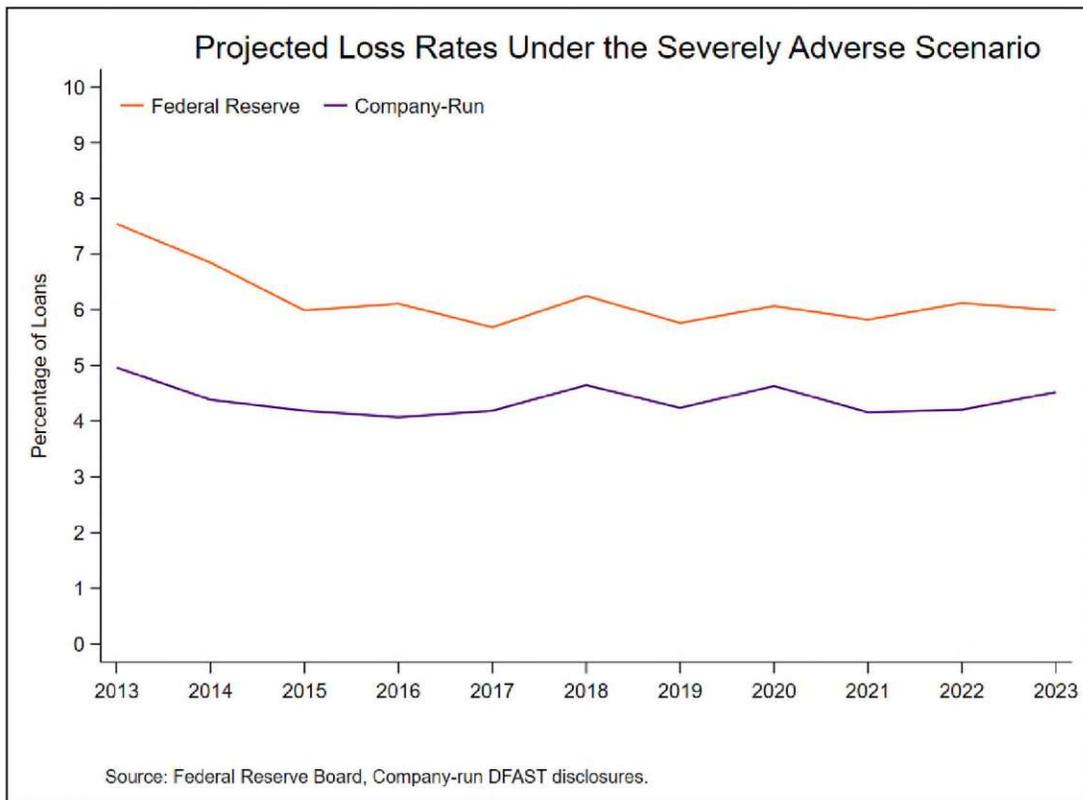
Banks subject to DFAST have adopted the current expected credit loss ("CECL") framework as of January 1, 2020, in both their business-as-usual operations and capital stress tests. However, the supervisory stress testing methodology still uses the incurred loss model framework for calculating allowances for credit losses. The Federal Reserve may incorporate CECL into DFAST as early as 2025.<sup>78</sup> Determining appropriate allowances under CECL is a complex process, which can have a significant impact on the supervisory stress test results and SCB requirement.

In addition, the Federal Reserve's projections of losses have consistently been higher than banks' own projections (Figure 8 below includes all Category I through III banks, which adopted CECL in 2020 and report company-run results at least once every two years).

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<sup>78</sup> See Federal Reserve Board, "Comprehensive Capital and Analysis Review and Dodd-Frank Act Stress Tests: Questions and Answers," (Dec. 20, 2023), available at <https://www.federalreserve.gov/publications/ccar-gas/comprehensive-capital-analysis-and-review-questions-and-answers.htm> (noting that the Federal Reserve is "extending the period of time over which it will maintain the current framework for allowance for credit losses in the supervisory stress test through the 2024 stress test cycle," but that it "continues to evaluate future enhancements to the stress test approach").

Figure 8

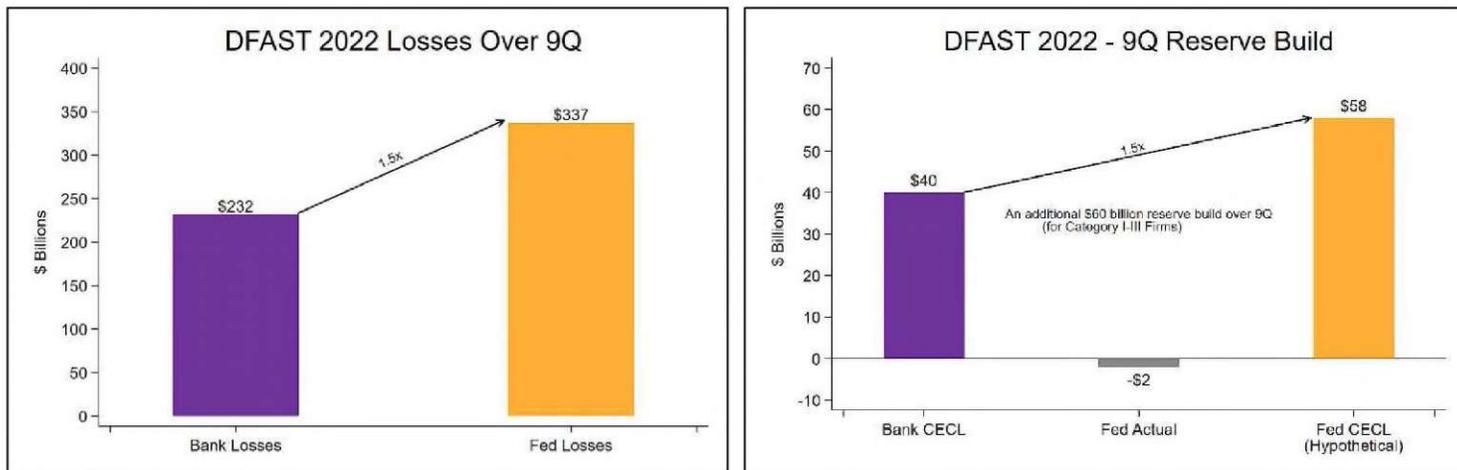


Losses from the supervisory stress test tend to be higher than banks’ own projections due to differences in loss-forecasting models (most likely driven by differences in assumptions around loss given default) and balance sheet assumptions.

In setting the ACL, the assumption of imperfect foresight plays a critical role in banks’ implementation of CECL reserving in stress testing. Economic forecasts often have a lag in detecting recessions, leading to gradual reserve builds over multiple quarters, mirroring banks’ own actions in real time. The same applies to recognizing improvements in economic conditions post-stress, resulting in gradual releases over multiple quarters. There are alternative ways to model the gradual build of allowances for credit losses under imperfect foresight. However, even the longest period would result in earlier recognition of provisions compared to the current supervisory methodology in DFAST. The choice of approach to simulate CECL reserving in the stress test would significantly impact capital requirements for most banks. An unrealistic approach with perfect foresight or a rapid reserve build would result in higher capital needs under stress, all else being equal.

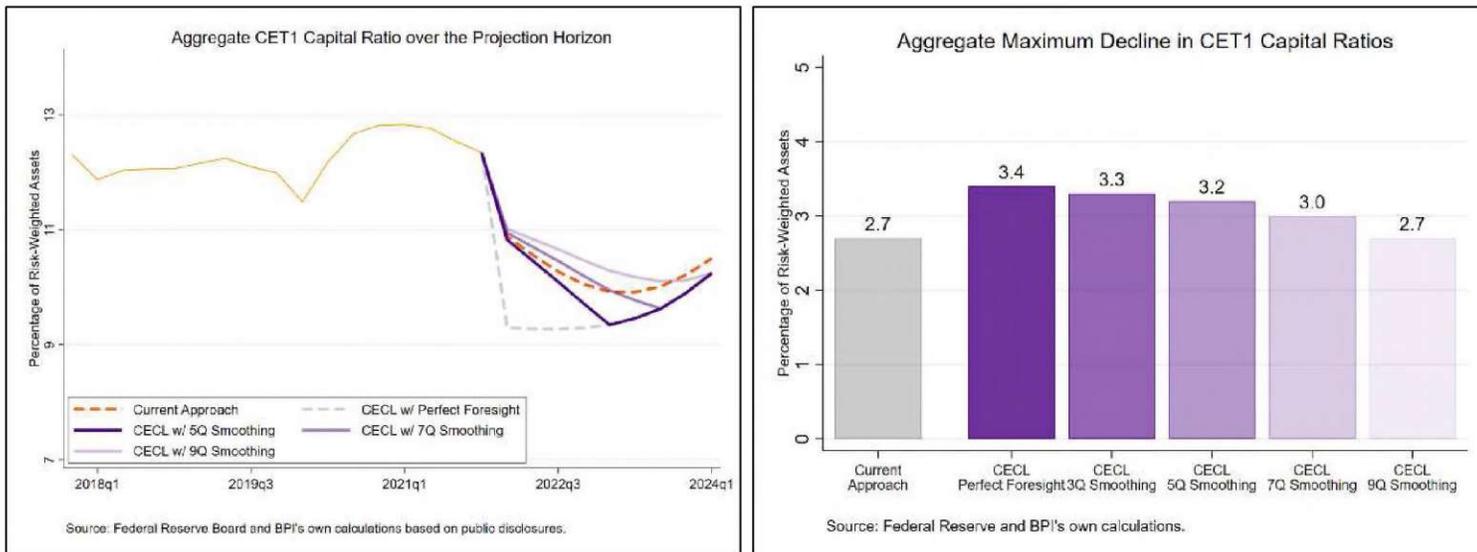
As shown in the chart below, if the Federal Reserve does not make changes to the supervisory loss models and essentially replicates banks’ own CECL methodologies, the projections of provisions for loan losses would increase in DFAST and raise capital requirements through the SCB.

Figure 9



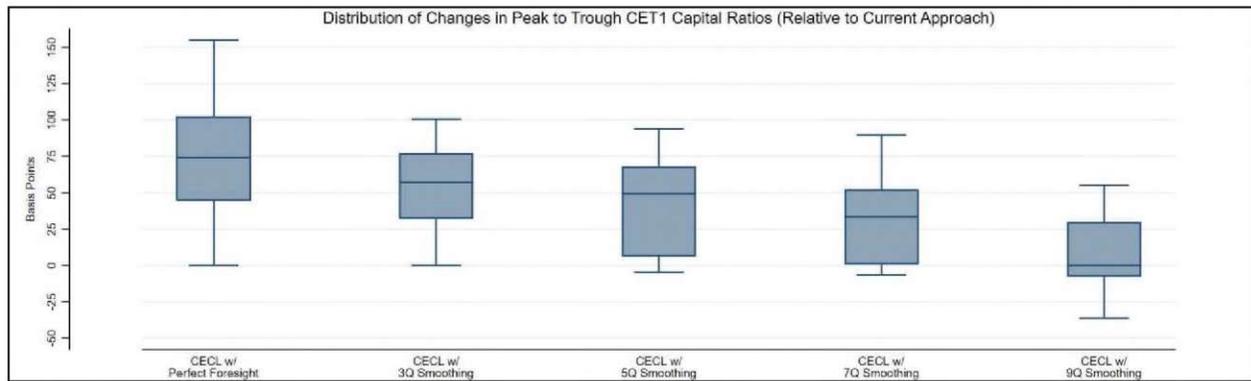
We can estimate the effect of adopting CECL on the SCB and the assumption of perfect foresight using a simple top-down model, and we find that bank capital requirements could increase by an additional 50 to 60 basis points compared with the Federal Reserve’s current approach.

Figure 10



Moreover, the effect of the incorporation of CECL on the maximum decline in CET1 capital ratios depends on the composition of banks’ own portfolios. The increase in SCB requirements could be as high as 100 basis points for certain banks. This impact is likely even higher because this estimate does not consider the impact of higher deferred tax assets (“DTAs”) related to CECL allowances and threshold deductions for DTAs.

**Figure 11**



If the Federal Reserve decides to incorporate CECL into DFAST, it should revisit the assumptions of its loss models to move them in line with the experience that it has accumulated over the post-crisis period.

4. The Federal Reserve should address timing considerations that could result in unintendedly high SCBs.

If the Federal Reserve does not adopt the recommendation not to apply the SCB to capital requirements under the Expanded Risk-Based Approach, it should address timing considerations that could result in unintendedly high SCBs. Because of the flat balance sheet/RWA assumption in the Federal Reserve’s Stress Testing Policy Statement,<sup>79</sup> the SCB is generally based on the ratio of stress losses to actual RWAs as of the prior year-end. For any given amount of stress losses, as RWAs increase, the SCB declines. For most banks, RWAs under the Expanded Risk-Based Approach are expected to be higher – and, in a number of cases, significantly higher – than RWAs under the Standardized Approach. If a bank’s RWAs increase on July 1, 2025 because RWAs under the Expanded Risk-Based Approach are higher than RWAs under the Standardized Approach, that bank could face an unintended increase in capital requirements because of the application of the SCB, which is based on RWAs under the Standardized Approach, to capital ratios calculated using the higher RWAs under the Expanded Risk-Based Approach.

The below table highlights how the mismatch in timing of SCB and the Expanded Risk-Based Approach phase-in results in a bank being over-capitalized during the transition period:

**Figure 12**

Period Start	Period End	Actual RWA	SCB RWA	Actual RWA (\$)	SCB RWA (\$)	SCB \$	SCB%	SCB% x Actual RWA	Excess Capital
7/1/2025	9/30/2025	ERBA point in time	Standardized as of Dec 2023	125.0	100.0	5.0	5.0%	6.3	<b>1.3</b>
10/1/2025	9/30/2026	ERBA point in time	Standardized as of Dec 2024	131.3	105.0	5.3	5.0%	6.6	<b>1.3</b>

<sup>79</sup> See 12 C.F.R. 252, Appendix B, § 3.4(a) (“In projecting risk-weighted assets, the Federal Reserve will generally assume that a covered company’s risk-weighted assets remain unchanged over the planning horizon.”).

In order to adjust for the timing issues highlighted above, if the Federal Reserve does not apply a static 2.5 percent buffer requirement to capital requirements under the Expanded Risk-Based Approach, the Federal Reserve should (i) align the phase-in of the Expanded Risk-Based Approach with the effective date of the SCB (*i.e.*, October 1) and (ii) apply one of the following adjustments:

- Apply a static 2.5 percent buffer requirement to capital requirements under the Expanded Risk-Based Approach until the Expanded Risk-Based Approach is fully phased in as of December 31 of the prior year, after which the Federal Reserve can calculate an SCB using the Expanded Risk-Based Approach beginning October 1, 2029;
- Apply a static 2.5 percent buffer requirement to capital requirements under the Expanded Risk-Based Approach beginning October 1, 2025 and, for subsequent years, use a fully phased-in Expanded Risk-Based Approach to calculate the SCB beginning October 1, 2026;<sup>80</sup> or
- Apply a static 2.5 percent buffer requirement to capital requirements under the Expanded Risk-Based Approach for the first year beginning October 1, 2025 and, for subsequent years, adjust the SCB to account for the difference between the percentage used in calculating the SCB and the current phase-in percentage (*e.g.*, 80 percent/85 percent for SCBs effective October 1, 2026).

The utility of any phase-in arrangement is to permit time for banks to reach the end-state requirement and allow stakeholders and regulators to measure banks' progress toward that end state on a quarterly basis. Accordingly, the transition period should avoid abrupt and discontinuous changes in capital requirements that do not reflect data, analysis, or a bank's actual economic exposures but instead result from unintended interactions between two different aspects of the capital framework that have developed separately over time. In addition, the introduction of the revised approach for calculating market risk RWAs for purposes of Standardized Approach capital requirements would make the existing Standardized Approach RWA calculations more conservative, so there is no scenario in which banks' capital requirements would decrease during the transition period due to an approach that addresses the interaction between the Expanded Risk-Based Approach and the SCB framework in a coherent fashion.

Finally, the Federal Reserve should revise the proposal to clarify that it would use only RWAs calculated under one approach (either the Standardized Approach or Expanded Risk-Based Approach) in the supervisory stress test for any firm for any year. This clarification would address an aspect of the proposal that, if read literally, suggests the interaction between the proposal and the Stress Testing Policy Statement could have the unintended effect of using RWAs under the Standardized Approach *and* the Expanded Risk-Based Approach over the course of the nine-quarter stress testing horizon to calculate SCBs. The Stress Testing Policy Statement provides, in relevant part: (i) "the Federal Reserve will generally

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<sup>80</sup> As an alternative, the Federal Reserve could, during the transition period, adjust SCB calculations to assume a 100 percent phase-in of RWAs under the Expanded Risk-Based Approach for all quarters in the stress test (including the December 31 jump-off point) so that an SCB that applies to Expanded Risk-Based Approach capital requirements is based on RWAs under the Expanded Risk-Based Approach, instead of RWAs under the Standardized Approach. We acknowledge, however, that this alternative would be complex, and probably unduly complex, particularly in the first year because it would be necessary for firms to report estimated RWAs under the Expanded Risk-Based Approach before the Expanded Risk-Based Approach takes effect.

assume that a covered company’s [RWAs] remain unchanged over the planning horizon,” and (ii) “the Federal Reserve will account for the effect of changes associated with the calculation of regulatory capital *or changes to the Board’s regulations in the calculation of [RWAs].*”<sup>81</sup> The proposal would amend the definition of “regulatory capital ratio” for purposes of the regulations governing the supervisory stress test to provide that “regulatory capital ratios may be calculated using each of 12 C.F.R. part 217, subpart D, and 12 C.F.R. part 217, subpart E.”<sup>82</sup> In contrast, the proposal would amend the definition of “regulatory capital ratio” for purposes of the regulations governing the company-run stress test to provide that a “covered company must calculate its regulatory capital ratios using either 12 C.F.R. part 217, subpart D, or 12 C.F.R. part 217, subpart E, whichever subpart resulted in the higher amount of total [RWAs] as of the last day of the previous stress test cycle.”<sup>83</sup> The differences between the two proposed definitions appear to contemplate that the Federal Reserve may use RWAs under both the Standardized Approach and the Expanded Risk-Based Approach in the supervisory stress test. The SCB is calculated as the start-to-trough decline in a firm’s CET1 capital ratio. If the Federal Reserve projects that RWAs will increase in the 2025 supervisory stress test because of the July 1, 2025 effective date of the proposal, as the italicized language from the Stress Testing Policy Statement could be read to suggest, the corresponding increase in RWAs and decline in CET1 capital ratios could factor into banks’ SCBs. Factoring such a decline into SCB capital ratios does not appear to be intentional, nor would it make conceptual sense. Accordingly, the Federal Reserve should clarify the proposal to prevent this unintended outcome.

**C. The inclusion of operational risk in the Expanded Risk-Based Approach is duplicative and results in a material overstatement of the capital that must be held against operational risk.**

Another key source of the proposal’s massive over-calibration of the capital requirements is its introduction of a new standardized approach for calculating a bank’s operational risk capital requirements. Under this standardized approach, a bank’s operational risk capital requirements would be a function of the BIC and a firm-specific ILM. The BIC would be calculated based on the sum of three components – an interest, lease and dividend component; a services component; and a financial component – multiplied by a scaling factor that increases from 0.12 to 0.18 as the business indicator rises. The ILM would be based on the ratio of a bank’s historical operational losses to its BIC, generally increasing the bank’s operational risk capital requirement as historical operational losses increase.

The proposal would introduce, for the very first time, an operational risk capital charge that is both added to credit risk capital charges calculated using standardized risk weights rather than internal models and subject to stress-based capital requirements. This represents a significant departure from the agencies’ past policy. In prior rulemakings, the agencies have expressly declined to add incremental operational risk capital charges to RWAs calculated using standardized risk weights because “the general risk-based capital rules include a buffer for risks not easily quantified (for example, operational risk and concentration risk), [therefore] general banks would not be subject to an additional direct capital charge for operational risk.”<sup>84</sup> The proposal would continue that approach for the existing Standardized Approach. But it would deviate from that approach by adding, under the new Expanded Risk-Based Approach, an operational risk capital charge to the RWAs calculated using the Expanded Risk-Based

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<sup>81</sup> 12 C.F.R. 252, Appendix B, § 3.4(b) (emphasis added).

<sup>82</sup> 88 Fed. Reg. at 64,326.

<sup>83</sup> *Id.*

<sup>84</sup> See Risk-Based Capital Guidelines; Implementation of New Basel Capital Accord, 68 Fed. Reg. 45,900, 45,902.

Approach's new standardized risk weights for credit risk. On top of that, the capital requirements resulting from the Expanded Risk-Based Approach would also be subject to the SCB, which imposes a material additional capital charge for operational risk.

The conceptual design presents two mutually exclusive possibilities. First, the addition of operational risk to the Expanded Risk-Based Approach could be duplicative, illogical and inappropriate (because operational risk remains implicitly covered by the Expanded Risk-Based Approach's new credit risk weights). Second, the Expanded Risk-Based Approach's new credit risk weights could have been carefully calibrated so as to quantify and subtract from those risk weights any portion of the risk weight captured by the Expanded Risk-Based Approach's operational risk capital charge. The second seems unlikely, as neither the proposal nor the Basel Committee's work in connection with its 2017 revisions contains any description of the relationship between the Expanded Risk-Based Approach's standardized credit risk weights and operational risk, let alone a statement of how these risk weights were calibrated so as to remove the implicit coverage of operational risk. Moreover, some risk weights remain unchanged or are even higher relative to the existing Standardized Approach, eliminating any possibility that they have been calibrated to exclude operational risk. According to the agencies' own impact analysis, credit RWAs are lower by approximately \$400 billion under the Expanded Risk-Based Approach, while operational RWAs are higher by \$1,950 billion. Thus, the agencies are effectively adding operational risk RWAs to a framework that already implicitly accounts for operational risk. It therefore appears that the agencies have reversed their prior position on the relationship between operational risk and standardized credit risk weights for no stated reason in favor of a policy that, as described below, is not based on a reasonable assessment of the correlation among these risk categories.

Based on analysis released by the agencies, the new operational risk charge accounts for nearly 90 percent of the increase in banks' capital requirements under the proposal. The agencies provide no analysis to explain why it is appropriate that the bulk of the increase is from operational risk. Our analysis shows the operational risk charge is materially overstated for three important reasons:

- Banks already must capitalize for operational risk losses in the SCB and stress tests, but the proposal's operational risk calibration takes no account of this fact;
- The standardized approach to operational risk overstates capital requirements relative to historical losses; and
- The approach assumes a perfect correlation of extreme operational risk losses with credit risk and market risk losses.

First, banks already capitalize for operational risk losses in the stress tests. As discussed in more detail in Section III.B.1 above, we estimate that the inclusion of operational risk losses in the stress tests results in an average decline of 118 basis points in the CET1 capital ratio for each bank. Considering that the aggregate RWAs of these banks currently amount to \$11,670 billion, this equates to an operational risk capital requirement of approximately \$138 billion (*i.e.*,  $\$11,670 \times 118/10,000$ ).<sup>85</sup>

The combination of both the new standardized approach for operational risk and the stress test

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<sup>85</sup> See Francisco Covas, *About Excessive Calibration of Capital Requirements for Operational Risk*, Bank Policy Institute (Oct. 30, 2023), available at <https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk/>, and attached as Appendix 14.

capital charge would result in a substantial overstatement of capital requirements for operational risk. To assess the amount of this overstatement, we compare the year with the highest operational risk losses recorded in data collected by ORX, the largest source of industry data on operational risk losses,<sup>86</sup> against the aggregate operational risk capital that banks would be required to maintain under both the Expanded Risk-Based Approach and the Federal Reserve’s stress tests. This comparison presents a challenge primarily because ORX does not disclose the identities of the U.S. banks in its sample, and it is therefore impossible to compare the same sample of firms on both metrics. For this reason, we calculate the capital charges under the Expanded Risk-Based Approach and those in the stress tests in relation to banks’ total revenues.

According to ORX data, 2008 was the year with the largest operational risk losses. As illustrated in Figure 13 below, these losses, relative to bank revenues in that year, amounted to 13.5 percent. ORX reports operational risk losses based on the event date (*i.e.*, it consolidates all individual operational losses relating to a single event and reports them in the period in which the underlying event occurred, regardless of when those operational losses were recognized for accounting purposes). Our analysis of the quarterly FR Y-9C data demonstrates that those losses were, in fact, distributed over a significantly longer period. For this reason, calculating those losses based on the date of recognition for accounting purposes results in a more realistic estimate of operational risk losses relative to revenues that is somewhat lower, that is, approximately 9.9 percent of total revenues.<sup>87</sup>

In contrast, according to the agencies’ own estimates, the proposed capital charge for operational risk would be \$156 billion. In 2022, the banks subject to the proposal reported total revenues of \$842 billion, meaning the new operational risk charge would represent 18.5 percent of those banks’ total revenues. Moreover, operational risk losses under the stress tests were approximately \$138 billion, accounting for 16.4 percent of the total revenues for the banks included in the 2022 stress tests. Together, the proposed operational risk capital charge and the operational risk capital charge from the stress tests would be 34.9 percent of banks’ revenues in 2022.

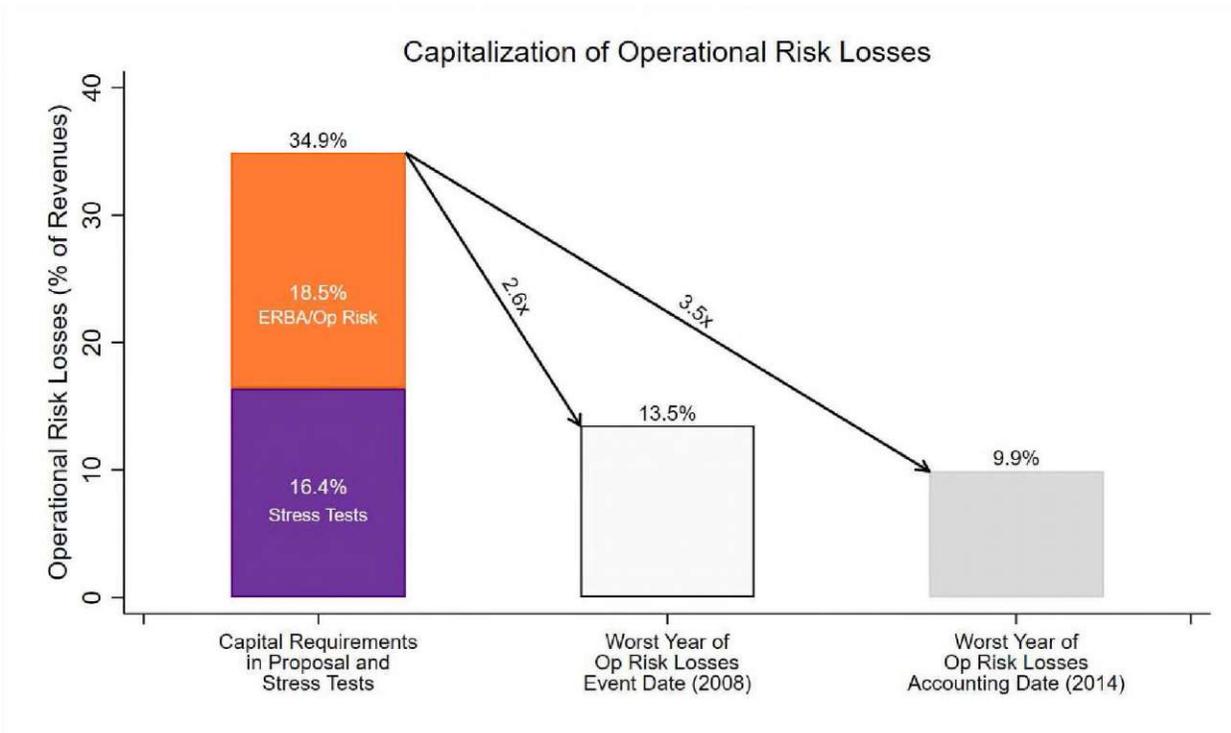
Based on the event date-based calculation of losses, the expected total operational risk capital charge after implementation of the proposal would therefore be 2.6 times the amount of the worst year of industry operational risk losses. However, this method significantly overestimates the operational risk losses incurred in the worst year. The more accurate accounting date-based method shows that the expected charge would be closer to 3.5 times those losses.

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<sup>86</sup> [ORX](#) is the largest operational risk management association in financial services, owned and driven by member institutions, which include some of the largest global banks. ORX has the largest and most comprehensive dataset on operational risk losses dating back to the early 2000s.

<sup>87</sup> We were able to find litigation reserves by date for only the top three banks that incurred the largest operational risk losses. Consequently, if the sample of banks for which we have operational risk losses by accounting date were to match the ORX sample, the reported operational risk losses relative to revenues would be lower than 9.9 percent.

Figure 13

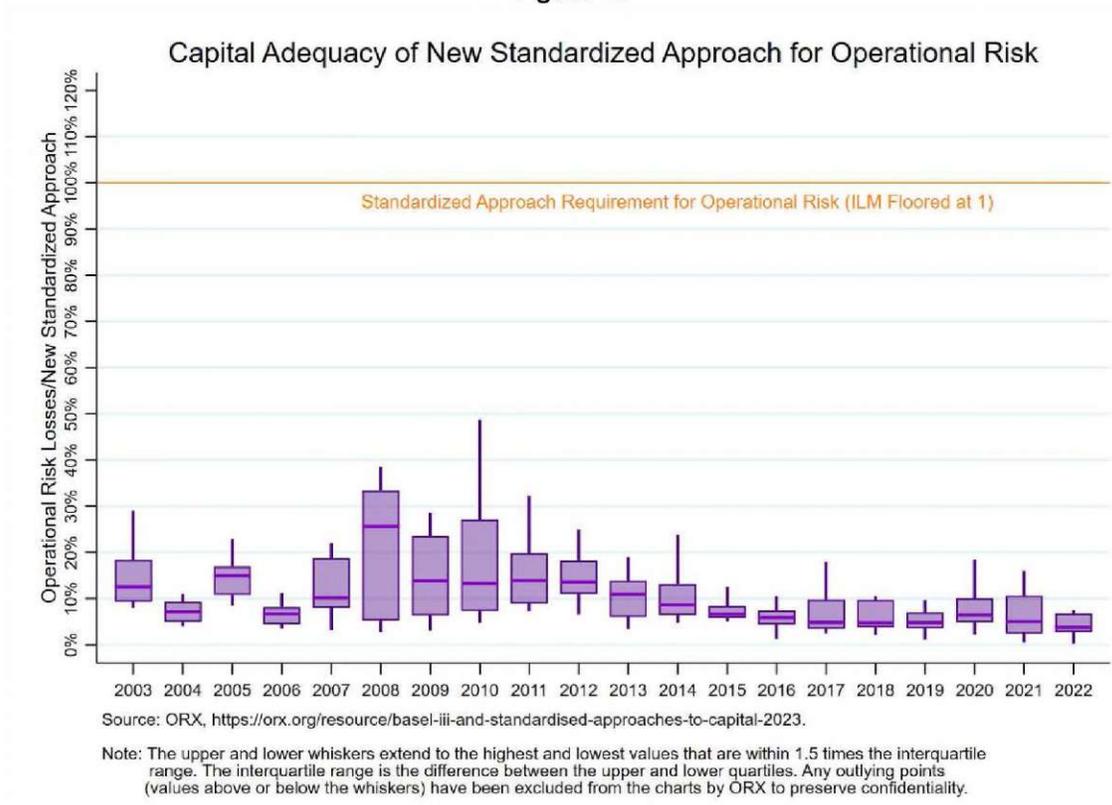


Second, data collected by ORX indicate that the new operational risk framework is over-calibrated as compared to historical loss data. In October 2023, ORX published a report that used 21 years of operational risk loss data to assess the calibration of the new standardized approach for operational risk, including the version included in the proposal.<sup>88</sup> The ORX report analyzes data on operational risk losses across various business lines. The ORX report also examines the capital adequacy of the Expanded Risk-Based Approach for operational risk among banks. Figure 14 plots the distribution of operational risk losses for each bank relative to the capital charge associated with the proposed standardized approach for operational risk included in the Expanded Risk-Based Approach, excluding the capital charges incorporated in the SCB. Specifically, it demonstrates that during the Global Financial Crisis, average operational risk losses were almost always less than 30 percent of the capital required under the new standardized approach for operational risk.<sup>89</sup> Moreover, the ORX loss data are reported at the event level, which means that losses spanning multiple years are consolidated into a single year. Consequently, the operational risk losses shown in Figure 14 during the Global Financial Crisis are considerably higher than what banks actually recognized in those years.

<sup>88</sup> See O.R.X., “Basel III and standardised approaches to capital,” (Oct. 2023), available at <https://orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023>.

<sup>89</sup> The results provided by ORX assume the ILM is floored at one, as in the U.S. proposal. The upper and lower whiskers extend to the highest and lowest values that are within 1.5 × the interquartile range. The interquartile range is the difference between the upper and lower quartiles. Any outlying points (values above or below the whiskers) have been excluded from the charts by ORX.

Figure 14



Third, operational risk losses are unlikely to coincide with large market, credit and CVA risk losses, *i.e.*, with the risk stripes that are separately capitalized under the proposal. The proposed rule’s calculation of regulatory capital involves summing RWAs arising from credit risk, market risk, operational risk and CVA risk. This method presumes that extreme losses in derivatives and credit, market and operational risks will all occur simultaneously, with a correlation of 1.0. For instance, under the 99.9 percent confidence interval assumed in the current Advanced Approaches,<sup>90</sup> it would mean that, if credit risk losses are in the 0.1 percent tail of the distribution of credit losses, the same is true for market risk losses, operational risk losses and CVA losses. This scenario is extraordinarily unlikely and without historical precedent. Therefore, the introduction of an explicit capital charge for operational risk into the binding capital requirement framework significantly overstates the capital requirements imposed on banks.<sup>91</sup>

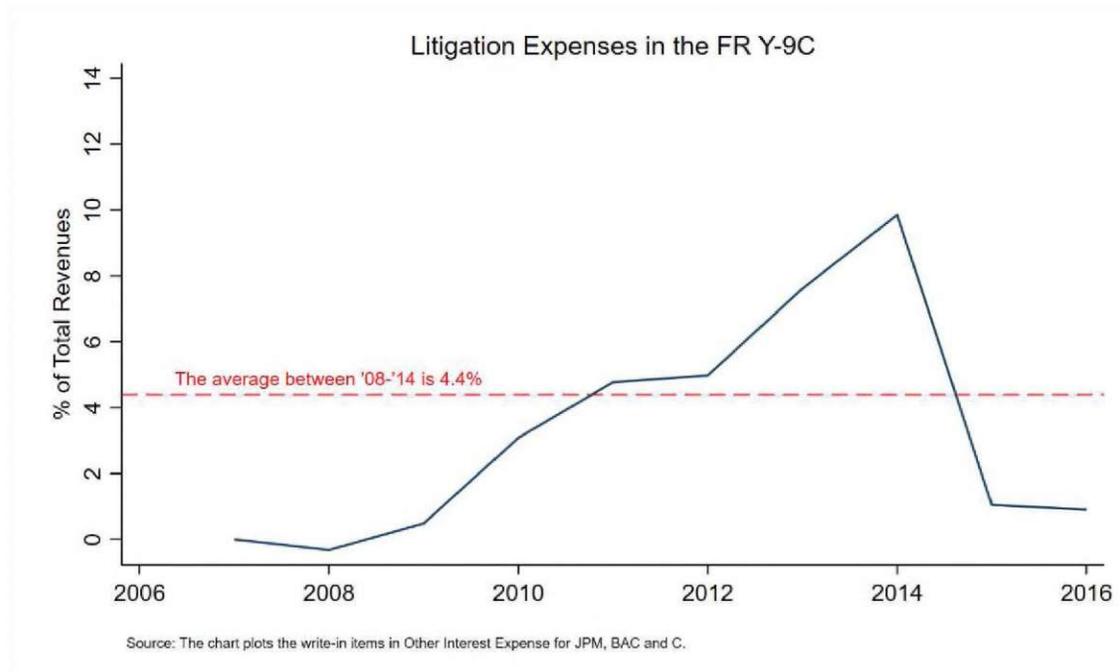
For example, the largest operational risk losses banks incurred during the period covered by the ORX analysis were associated with mortgage underwriting and securitization leading up to the Global Financial Crisis. As illustrated with litigation expenses in Figure 15 below, banks incurred the bulk of those losses several years after the Global Financial Crisis (when banks incurred most of their derivatives, credit and market risk losses) because it takes time to bring forward legal claims and resolve those claims, which

<sup>90</sup> See “operational risk exposure” in 12 C.F.R. §§ 3.101; 217.101; 324.101.

<sup>91</sup> See Joshua V. Rosenberg and Til Schuermann, *A general approach to integrated risk management with skewed, fat-tailed risks*, J. Fin. Econ. Vol. 79 Issue 3, 569, 614 (March 2006) (estimating that the capital requirements could be overstated by about 30 to 40 percent), available at <https://doi.org/10.1016/j.jfineco.2005.03.001>.

intuitively suggests that correlation between operational risk and other risk is low.

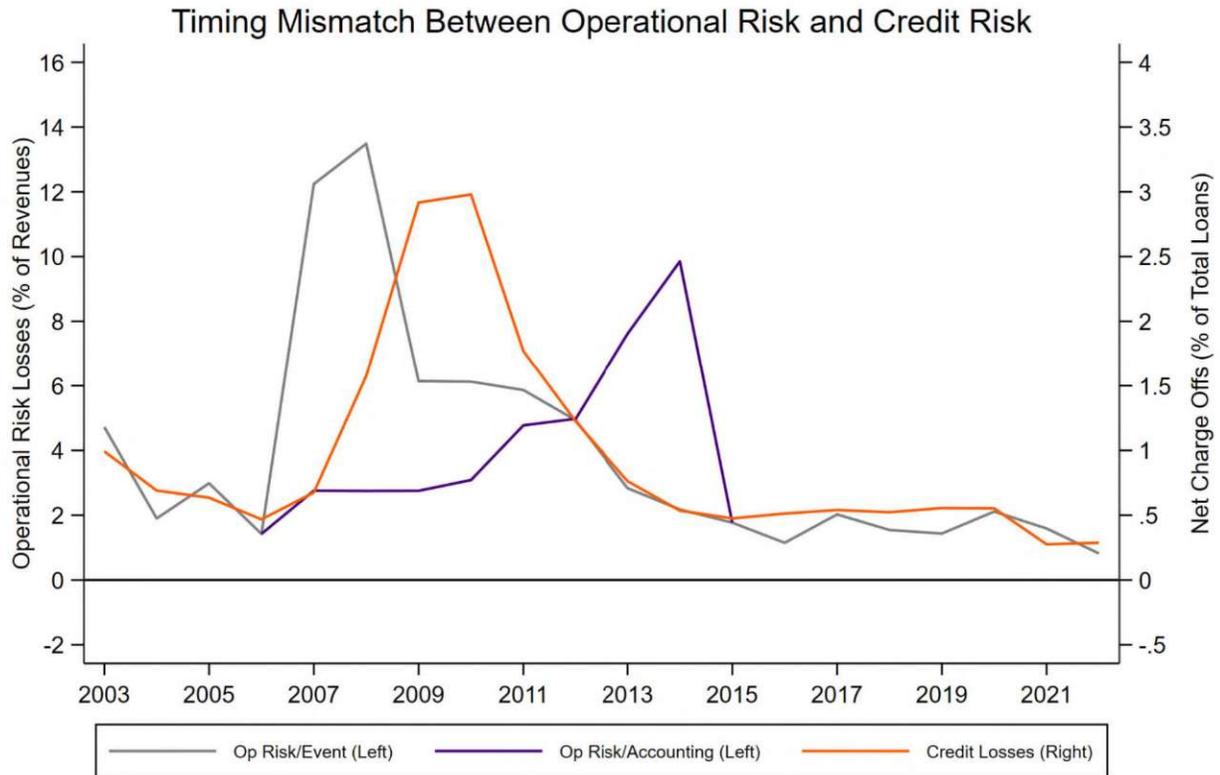
Figure 15



Comparing the timing of credit and operational risk losses bears this out. Some comparisons between operational risk losses and credit losses use the event date (the date on which the event prompting the loss occurred), but use of this date is misleading with respect to litigation losses or fines because the actual recognition of the operational loss – either through establishment of a reserve or payment of a judgment, fine or settlement – generally occurs years after the event that gave rise to the recognition of those losses. The use of event date is particularly misleading for the 2008 – 09 period, as it assumes all operational losses from legal judgments, fines and settlements associated with the Global Financial Crisis were incurred and recognized around the same time and concurrently with the recognition of credit and market losses. Using accounting date (*i.e.*, when the loss was actually recognized) shows that large operational risk losses do not tend to be recognized (*i.e.*, affect capital) contemporaneously with credit (and market) losses, as shown in Figure 16 below.<sup>92</sup>

<sup>92</sup> To estimate the accounting date for the period between 2008 and 2014, we utilized the write-in fields for other noninterest expenses in the quarterly FR Y-9C data. The specific text fields we referred to included “Litigation Expense,” “Litigation and Regulatory Proceedings,” “Release of Litigation Reserves,” “Foreclosure Expense” and “OREO Expenses.” The agencies have access to confidential supervisory data that could enable a more precise estimation of the correlation between operational risk losses and credit losses.

Figure 16



Due to these fundamental issues with the conceptual framework underpinning the operational risk elements of the Expanded Risk-Based Approach, and its resulting massive over-calibration of the operational risk capital charge, it is imperative that the agencies significantly revise and drastically lower the calibration of the operational risk capital charge required by any final rule. We propose specific adjustments in Section V below.

- D. Uniform use of eight percent as the assumed binding capital requirement for purposes of translating notional capital charges to RWA amounts, particularly in the context of operational risk, is distortive and leads to excessively high capital requirements and therefore should be corrected.**

There are several elements of the capital framework (both existing and proposed) that use formulas for translating capital charges to RWA amounts, or vice versa. For the purposes of these calculations, the framework assumes a uniform eight percent minimum capital requirement. So, for example, \$100 in RWA would be assumed to produce an \$8 capital charge, and a \$100 capital charge would be assumed to equate to \$1,250 in RWA. This uniform mechanism fails to account for differences among institutions’ binding capital requirements (in the international framework, largely stemming from the static capital conservation buffer plus any GSIB surcharge or countercyclical capital buffer, and in the U.S. framework, stemming from any GSIB surcharge and the applicable SCB), and thereby systematically understates the true capital charges associated with different assets and activities, and results in an overstatement of RWA amounts and an over-calibrated framework.

The operational risk calculation is a good example of this issue, although it exists everywhere eight percent is the assumed minimum capital requirement for purposes of calculating RWAs or notional capital

charges. As described above, because the standardized approach for operational risk does not involve assessing the operational risk associated with each asset, exposure or activity, but instead involves assessing the operational risk of an organization in its entirety, the assessment of a bank’s operational risk must be translated into a RWA equivalent for purposes of allowing operational risk to be factored into the bank’s risk-based capital ratios.

The standardized approach for operational risk therefore starts by calculating the amount of capital that a bank should be required to hold against operational risk – *i.e.*, what could be thought of as the numerator of a bank’s risk-based capital ratio requirement. To combine that operational risk capital requirement with the RWA-based credit and market risk capital requirements for purposes of assessing a bank’s *overall* risk-based capital requirement, the operational risk capital amount must be translated into a notional RWA amount. This amount would then be added to the bank’s credit and market RWAs to arrive at the organization’s total RWAs.

This translation of operational risk capital into RWAs and back to capital, combined with other aspects of the U.S. capital framework, results in an over-calibration of the actual amount of capital required to be held. This distortion can be addressed by multiplying the capital by an “institution-specific factor” (“ISF”).<sup>93</sup>

The following example illustrates this capital distortion:

**Figure 17**

	<b>\$ Billion, Unless Otherwise Stated</b>
Operational Risk Capital	10.0
Hence, Operational RWA	125.0
<hr/>	
Total Capital Requirement (8.0% Minimum Requirement Plus 2.5% Buffer Requirement)	10.5%
Capital Required for Operational Risk	13.1
Capital Distortion	3.1, or ~30% additional

Thus, the operational risk capital charge of \$10 billion calculated in this example under the standardized approach for operational risk translates into a \$13.1 billion charge when considered from a

<sup>93</sup> A similar institution-specific approach should be applied in all instances where the eight percent minimum capital requirement is assumed, in particular in the calculation of CVA RWAs and market risk RWAs, which, like the calculation of operational risk RWAs, use a multiplier of 12.5.

minimum capital point of view. This additional \$3.1 billion results from flowing the amount of operational risk capital to RWAs and back and represents an over-calibration of the amount of operational risk capital.

This arises because the operational risk RWAs are derived by multiplying the operational risk capital number by 12.5. The 12.5 multiplier is based on the eight percent minimum total capital requirement (12.5 being the inverse of eight percent). This comprises a minimum 4.5 percent CET1 and the remaining 3.5 percent being other capital tiers. The inclusion of the SCB and GSIB surcharge in the U.S. context results in each bank having its own effective minimum capital requirement. This ranges from CET1 requirements of seven percent to as high as 13.8 percent per the Federal Reserve’s 2023 DFAST.<sup>94</sup> As a result, the total capital requirement effectively ranges from 10.5 percent to 17.3 percent for banks. The example above illustrates the capital distortion for a firm with a 10.5 percent binding capital requirement. At 17.3 percent, the distortion would be even greater, and more than double an operational risk capital charge calibrated to an eight percent requirement.

To avoid this over-calibration, translating a bank’s capital charges to RWA amounts, or vice versa, should involve the application of a yearly ISF, rather than a static eight percent assumption. The ISF would reflect the bank’s SCB and GSIB surcharge as follows:

$$ISF = \frac{8\%}{8\% + SCB + GSIB\ Surcharge}$$

In the context of operational risk, operational risk capital would then be multiplied by 12.5 and the ISF to arrive at operational RWA without the distortion:

$$Operational\ Risk\ RWA = 12.5 \times ISF \times Operational\ Risk\ Capital$$

Applying the ISF to any translations between capital charges and RWAs would address over-calibration wherever the static eight percent assumption is currently used. In the case of operational risk, this approach could cut the over-calibration of operational risk capital in approximately half.

**E. The agencies should maintain differentiation in capital requirements for banks in Categories I through IV and should revise the application of the new market risk capital rule to exempt banks with limited trading activities.**

The agencies should maintain differentiation in capital requirements for banks in Categories I through IV, as required by the statute,<sup>95</sup> and should revise the application of the new market risk capital rule to exempt banks with limited trading activities.

1. Maintaining differentiation in capital requirements for banks in Categories I through IV is consistent with the letter and spirit of the law.

The proposal would provide for almost complete alignment in capital ratio calculations and requirements for banks in Categories I through IV, including by (i) requiring banks in Categories I through IV to calculate RWAs in the same manner, including by requiring Category III and IV banks to – for the first

<sup>94</sup> Board of Governors of the Federal Reserve, “Large Bank Capital Requirements,” (July 2023), available at <https://www.federalreserve.gov/publications/files/large-bank-capital-requirements-20230727.pdf>.

<sup>95</sup> 12 U.S.C. § 5365(a)(2)(A) (requiring differentiation in the application of prudential standards based on capital structure, riskiness, complexity, financial activities, size and any other risk-related factors).

time – move to a dual-stack approach previously only required for Category I and II banks; (ii) requiring Category III and IV banks to recognize unrealized gains/losses on AFS debt securities and most other elements of AOCI in regulatory capital, subject to a phase-in period, as discussed below; (iii) requiring Category III and IV banks to apply the capital deductions and minority interest treatments that are currently applicable only to Category I and II banks; (iv) applying the SLR and CCyB to Category IV banks; and (v) requiring all Category I through IV banks to calculate market RWAs under the revised market risk capital rule.

The proposed application of these requirements ignores the statutory requirements to tailor the application of prudential standards and, in the case of Category IV banks, to make a determination regarding the application of these standards. Section 165 of the Dodd-Frank Act includes three core, yet simple, requirements. It provides that the Federal Reserve shall (i) establish enhanced prudential standards for bank holding companies with \$250 billion or more in total consolidated assets;<sup>96</sup> (ii) differentiate the application of enhanced prudential standards (either on an individual basis or by category) based on a bank holding company’s capital structure, riskiness, complexity, financial activities, size or other risk-related factors;<sup>97</sup> and (iii) make a determination in order to apply enhanced prudential standards to any bank holding company or bank holding companies with total consolidated assets between \$100 billion and \$250 billion.<sup>98</sup> The Federal Reserve has previously recognized its capital rules as enhanced prudential standards satisfying the requirements of Section 165.<sup>99</sup> Therefore, with respect to bank holding companies, Section 165 requires the Federal Reserve to differentiate the application of capital requirements based on the enumerated statutory factors and, with respect to bank holding companies with total assets between \$100 billion and \$250 billion, to make a determination that the application of these standards is appropriate to prevent or mitigate risks to the financial stability of the United States or to promote the safety and soundness of the bank holding company or bank holding companies. The Federal Reserve has not proposed to differentiate, among other things, the calculation of RWAs or regulatory capital among Category I through IV banks<sup>100</sup> and has not publicly made the requisite determination. Consistent with the letter and spirit of the law, the Federal Reserve must do so before finalizing the requirements.

In addition, both the statutory directive to differentiate among banks in the application of prudential standards and the legislative history related to the enactment of S. 2155 make clear that Congress did not intend for uniformity of regulation for all banks with \$100 billion or more in total assets.<sup>101</sup> Contrary to the statutory purpose and congressional intent, the proposal would apply the new

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<sup>96</sup> See 12 U.S.C. § 5365(a)(1).

<sup>97</sup> See 12 U.S.C. § 5365(a)(2)(A).

<sup>98</sup> See 12 U.S.C. § 5365(a)(2)(C).

<sup>99</sup> See Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,246 (Mar. 27, 2014) (describing the capital rules and the capital planning rule as enhanced prudential standards).

<sup>100</sup> The GSIB surcharge and enhanced supplementary leverage ratio (“eSLR”), which are beyond the scope of the proposal, would continue to apply only to GSIBs (*i.e.*, Category I banks). The proposal would apply the Expanded Risk-Based Approach uniformly to all banks with \$100 billion or more in total assets, and aside from the GSIB surcharge and eSLR – and in stark contrast to the current framework – the proposal would revise the U.S. capital framework so all large banks calculate capital and RWAs in the same manner.

<sup>101</sup> See, *e.g.*, 164 Cong. Rec. at S1360 (Mar. 6, 2018) (statement of Sen. Mark Warner) (“Under the bill, the

capital framework uniformly to banks in Categories I through IV.<sup>102</sup> The Federal Reserve has appropriately implemented the statutory mandate by “establishing categories of standards that increase in stringency based on risk.”<sup>103</sup> The proposal would – unjustifiably and without any explanation – reverse that decision by effectively treating banks in Categories II through IV as a uniform category.

- 2. Category IV banks should only be subject to one capital stack and should not be subject to the CCyB or SLR.

To maintain differentiation in capital requirements for banks, consistent with the letter and spirit of the law,<sup>104</sup> Category IV banks should only be subject to one capital stack. Requiring these banks to calculate RWAs under both the existing Standardized Approach and the Expanded Risk-Based Approach would be unnecessarily cumbersome, would add significant cost and operational complexity without any clear supervisory benefit and could lead to an outcome in which these banks’ binding capital requirements oscillate between stacks. In addition, applying the Expanded Risk-Based Approach to Category IV banks would result in the application of more stringent requirements to these banks than those that applied prior to the enactment of S. 2155. The implementation burdens and ongoing operational costs of a dual-stack approach – as well as the requirement for Category IV banks to use SA-CCR, apply the FRTB-based market risk capital rule and calculate CVA RWAs without regard to the extent of their derivatives exposures or trading activities – outweigh any supervisory benefit or marginal increase to resiliency.

In addition, applying the same requirements for calculating capital and RWAs to all banks with \$100 billion or more in total assets, without any apparent consideration of the statutorily enumerated tailoring factors, would have far-reaching consequences on the banking industry in light of the “cliff” effects of crossing that threshold, including with respect to growth of banks, acquisition activity, the cost and availability of credit and the extent of mortgage servicing activity.

Finally, the CCyB and the SLR should not be applied to Category IV banks. If the agencies do apply these requirements to Category IV banks, they should provide for a differentiated application that reflects the smaller size and different risk profiles of these banks.

- 3. The agencies should establish thresholds for the application of the new market risk capital rule so that banks with limited trading activities are not subject to operationally burdensome new requirements.

Under the proposal, banks with less than \$100 billion in total assets would be subject to the new

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[Federal Reserve] can apply enhanced prudential standards to a bank with assets larger than \$100 billion for financial stability reasons or to promote the safety and soundness of the bank – part of their traditional prudential regulations as they stand, but I don’t think every enhanced prudential standard should apply to every bank with assets larger than \$100 billion. There is a broad agreement that standards should be tailored for this group.”).

<sup>102</sup> The Federal Reserve’s notice of proposed rulemaking to amend the GSIB surcharge methodology would also erode the differentiated application of prudential requirements, as that proposal indicates that several foreign banks would move up to a higher category without any changes to their risk.

<sup>103</sup> Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations, 84 Fed. Reg. 59,032, 59,037 (Nov. 1, 2019).

<sup>104</sup> See 12 U.S.C. § 5365(a)(2)(A).

market risk rule only if they have \$5 billion or more in trading assets plus trading liabilities, or trading assets plus trading liabilities that exceed 10 percent of total assets.<sup>105</sup> However, the new market risk rule would require all Category I through IV holding companies (and any depository institution subsidiary that has engaged in trading activity over any of the four most recent quarters) to calculate market RWAs under the revised market risk capital rule. This requirement would include banks not currently subject to the market risk capital rule because they have less than \$1 billion in aggregate trading assets plus trading liabilities, as well as other banks with between \$1 billion and \$5 billion in aggregate trading assets and liabilities.

Application of the new market risk capital rule to banks with limited trading activities would result in undue compliance and operational burdens that are not commensurate with their market risk exposures. Consistent with the longstanding application of the market risk capital rule, there should be thresholds for application. Specifically, a Category III or IV bank should not be subject to the market risk capital rule unless its aggregate trading assets plus trading liabilities equal or exceed \$5 billion or 10 percent of total assets. The agencies should maintain a threshold for Category III and IV banks because (i) they generally have low trading activity – and, in some cases, virtually no trading activity – and (ii) trading activity is generally related to customer-facilitation transactions (*e.g.*, an interest rate swap for a borrower on a commercial loan), not market-making transactions for customers that are not otherwise borrowers.

**F. Failing to calibrate the credit risk elements of the Expanded Risk-Based Approach to be consistent with the outputs of the Advanced Approaches would undermine the agencies’ professed goal of achieving a more risk-sensitive framework and result in arbitrarily high credit risk requirements.**

The serious overstatements of risk in the proposed standardized approach for credit risk described below in Section IV.A are greatly magnified by the agencies’ proposal to eliminate the use of internal models under the Advanced Approaches without regard to the risk weights those approaches generated. The agencies offer no evidence to support this major change from existing calibration of the capital risk weights, and considerable evidence suggests that it would make the capital regime less accurate. Therefore, to achieve appropriate risk-sensitivity and avoid excessively high capital requirements, the agencies should calibrate any standardized approach for credit risk to be generally consistent with the calibration of the existing Advanced Approaches. Although uniformity and simplicity may be desirable goals, they should not be achieved by sacrificing accuracy.

Furthermore, in both the proposal and their advocacy surrounding it, the agencies have repeatedly stressed their adherence to the Basel agreement of 2017. Therefore, it is noteworthy that the proposal’s calibration repudiates completely one of the most important aspects of that agreement, which is the continued use of bank internal models *subject to a floor established as 72.5 percent of the output of the standardized approach*<sup>106</sup> without any corresponding adjustment to the calibration of the standardized approach to account for the fact that 100 percent of the RWAs resulting from the standardized approach apply in the U.S. Agency staff negotiated that agreement, praised that agreement and have consistently emphasized the importance of consistent adoption of that agreement, but the agencies now propose to be

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<sup>105</sup> See 88 Fed. Reg. at 64,030.

<sup>106</sup> The Basel framework contemplates the continued use of internal models for credit risk, while also providing that implementing only the standardized approaches would not, in and of itself, constitute noncompliance with the Basel framework. See Basel Committee on Banking Supervision, *supra* note 14.

the only major jurisdiction in the world to abandon a core element of the agreement in favor of an approach that would result in systematically higher capital requirements than what that agreement contemplated. Moreover, although the agencies express concerns about variation in bank modeled results (without providing any evidence to show such variation), they ignore the fact that the entire point of the output floor negotiated at Basel was to constrain such variation. The standardized approach was not intended or calibrated to act as a standalone measure of credit risk, but that is exactly how the agencies propose to apply it in the United States.

Unless the agencies demonstrate that the results of the Advanced Approaches for credit risk have been inaccurate (the proposal does not do so), any final rule should calibrate the Expanded Risk-Based Approach to achieve outcomes that are empirically grounded in the evidence produced by the Advanced Approaches, even if adjusted as necessary to be generally consistent with those that would be produced under the models-based approaches under the revised Basel Committee standard.<sup>107</sup> This change would (i) more closely align the U.S. capital framework with the international standard, (ii) logically follow from the agencies' recognition that internal models can "provide valuable information to a bank's internal stress testing, capital planning, and risk management functions,"<sup>108</sup> (iii) improve risk-sensitivity<sup>109</sup> and (iv) avoid the excessive and incorrect calibration of credit risk capital requirements. Although the proposal argues that the use of models-based approaches for calculating credit RWAs involves assumptions that "include a degree of subjectivity" and has produced "unwarranted variability across banks in requirements for exposures with similar risks,"<sup>110</sup> these assertions ignore evidence that variability is, in fact, limited.<sup>111</sup> Further, we do not see some "degree of subjectivity" as a negative, and, in any event, it is considerably less of a negative than arbitrariness. In addition, the proposed disregard of the results of models-based approaches for calculating credit RWAs would put the United States at odds with both the central tenets of the Basel framework<sup>112</sup> and implementation of the Basel framework in other jurisdictions, such as the EU and the UK, which have proposed to retain the use of bank models for calculating credit RWAs.<sup>113</sup> Finally,

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<sup>107</sup> See Basel Committee on Banking Supervision, *Basel framework*, CRE 30 – 36 (March 27, 2020), available at [https://www.bis.org/basel\\_framework/index.htm?m=97](https://www.bis.org/basel_framework/index.htm?m=97).

<sup>108</sup> See 88 Fed. Reg. at 64,032.

<sup>109</sup> See Covas and Stepankova, *supra* note 10, and attached as Appendix 3.

<sup>110</sup> 88 Fed. Reg. at 64,031.

<sup>111</sup> See Covas and Stepankova, *supra* note 10, and attached as Appendix 3 ("In this note, we have shown that the systematic variation in risk weights under the revised standardized approach for corporate exposures (including investment funds) would be modest. This is particularly true where banks can use their own internal ratings to distinguish between investment grade and non-investment grade entities. The systematic variation in risk weights for publicly traded exposures is also not statistically different from the one observed for privately held entities.").

<sup>112</sup> The Basel Committee has explained that "[t]he revisions seek to restore credibility in the calculation of risk-weighted assets (RWAs) and improve the comparability of banks' capital ratios by . . . constraining the use of the internal model approaches, by placing limits on certain inputs used to calculate capital requirements under the internal ratings-based (IRB) approach for credit risk and by removing the use of the internal model approaches for CVA risk and for operational risk." See Basel Committee on Banking Supervision, *supra* note 14.

<sup>113</sup> See Prudential Regulation Authority, *CP16/22 – Implementation of the Basel 3.1 Standards*, 8.24 (Nov. 30, 2022), available at <https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards>; see also Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards

the proposed disregard of bank models as a way to address “unwarranted variability” ignores the fact that these models (i) include more granular data than standardized models and (ii) are subject to a rigorous backtesting process and overseen by an independent risk function, an independent model validation group, internal auditors and agency examiners.<sup>114</sup>

If the agencies ultimately eliminate the use of internal models for credit risk, they must, at a minimum, calibrate the Expanded Risk-Based Approach to credit risk to yield results that align broadly with those of the Advanced Approaches. This is necessary to prevent excessively high capital requirements for credit risk.

**IV. The Expanded Risk-Based Approach lacks sufficient risk-sensitivity and would result in excessive and incorrectly calibrated capital requirements for credit risk.**

Right-sizing capital requirements for U.S. banks requires making the fundamental changes described in Section III above; however, these changes alone do not fully address the proposal’s design and calibration limitations that would, if unchanged, lead to the broad over-capitalization of many individual products, services and business lines. We address these issues within the proposed credit risk framework in this Section IV.

**A. The proposed risk weights for credit significantly overstate actual risk and would have adverse consequences for both the cost and availability of credit for consumers and businesses.**

**1. The proposed risk weights for retail exposures are not based on an empirical assessment of actual risk and significantly overstate it.**

The risk weights for retail exposures in proposed Section 111(g), including credit card loans and auto loans, are significantly higher than historical loss experience could justify and 10 percentage points higher than the corresponding risk weights in the Basel framework. Additionally, there would be a new, 10 percent CCF applied to the unused portion of retail lines of credit that has no empirical basis and which would further inflate RWAs.

We urge the agencies to recalibrate the proposal’s risk weights for retail exposures based on an empirical analysis of the risk posed by these exposures, which we believe in most cases would be below, not above, the risk weights in the Basel framework. Doing so would be more risk-sensitive and also result in credit that is more affordable and readily available than under the proposed rule, thus mitigating the adverse effects of the proposal on consumers and the economy.

According to the FFIEC 101 reports, the average risk weight for credit card loans across banks using the Advanced Approaches was about 73 percent for the period from 2014 to 2022. This already includes the effect of a non-zero CCF for the unused portion of credit lines and reflects historical loss experience during a severe economic downturn. By comparison, the effective risk weight including the effect of the

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requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:52021PC0664>.

<sup>114</sup> Additional problems with the decision to eliminate the existing Advanced Approaches are identified in the accompanying letter focused on legal deficiencies with the proposal.

CCF is 98 percent under the Basel standard and 111 percent under the proposal.<sup>115</sup> Similarly, the average risk weight of other consumer loans is 50 percent for Advanced Approaches banks over the period from 2014 to 2022 (based on FFIEC 101 report data), compared to a risk weight of 85 percent under the proposal.<sup>116</sup>

Furthermore, there is no justification for the proposed 10 percent CCF: the agencies have not provided data or analysis to demonstrate that this is the appropriate CCF for banks. Available evidence suggests the contrary – that the CCF should be lower, as discussed further in Section IV.B.1 below.<sup>117</sup>

As with the increase to the risk weights for residential real estate exposures discussed below, the impact analysis in the preamble of the proposal indicates that the agencies proposed risk weights higher than the Basel standard to enhance the competitive position of smaller banks. Capital requirements are designed to improve the safety and soundness of the banks to which they apply.<sup>118</sup> There is no valid basis in law or logic for using capital requirements for competitive engineering. Not only is the justification invalid, but the premise is also demonstrably erroneous:

- All banks subject to the proposal face a substantial SCB charge for all retail exposures, given the large rise in unemployment rates assumed in the stress tests. The stress test add-on is particularly pronounced for credit card loans.<sup>119</sup> BPI has estimated the SCB RWA add-on for credit cards to be as high as 63 percentage points using the methodology of Greenwood, Hanson and Stein.<sup>120</sup> For other retail loans, the SCB add-on could be as high as 20 percentage points.

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<sup>115</sup> See Calem and Covas, *Retail Lending*, *supra* note 8, and attached as Appendix 2.

<sup>116</sup> See Calem and Covas, *Retail Lending*, *supra* note 8, and attached as Appendix 2.

<sup>117</sup> See “TCH Research Study: Empirical Analysis of BCBS-Proposed Revisions to the Standardized Approach for Credit Risk,” The Clearing House (May 2016), [https://bpi.com/wp-content/uploads/2018/07/20160519\\_tch\\_study\\_bcbs\\_standardized\\_approach\\_for\\_credit\\_risk.pdf](https://bpi.com/wp-content/uploads/2018/07/20160519_tch_study_bcbs_standardized_approach_for_credit_risk.pdf); see also Calem and Covas, *Retail Lending*, *supra* note 8, and attached as Appendix 2.

<sup>118</sup> See, e.g., Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 17,317, 17,319 (“Post-crisis regulatory reforms, including the capital rule, the eSLR rule, and the Board’s GSIB surcharge rule, were designed to improve the safety and soundness and reduce the probability of failure of banking organizations, as well as to reduce the consequences to the financial system if such a failure were to occur.”).

<sup>119</sup> See Board of Governors of the Federal Reserve, “2023 Federal Reserve Stress Test Results,” (June 2023), available at <https://www.federalreserve.gov/publications/files/2023-dfast-results-20230628.pdf> (showing that credit card loan loss rates in the 2023 stress tests were 17.4 percent, compared to 2.7 percent for domestic first-lien mortgages, and that projected credit card losses were \$120 billion, compared to \$65 billion, \$34 billion and \$7 billion in projected losses for domestic commercial real estate loans, first-lien mortgages and junior liens, respectively).

<sup>120</sup> See generally Robin Greenwood et al., *Strengthening and Streamlining Bank Capital Regulation*, Brookings Papers on Econ. Activity 479, 563 (Sept. 7, 2017), available at [https://scholar.harvard.edu/files/stein/files/greenwoodtextfa17bpea\\_002.pdf](https://scholar.harvard.edu/files/stein/files/greenwoodtextfa17bpea_002.pdf); see also Francisco Covas, *Estimating the Implicit Capital Charges in the Stress Tests*, Bank Policy Institute (Aug. 2, 2021), <https://bpi.com/estimating-the-implicit-capital-charges-in-the-stress-tests/>, and attached as Appendix 15.

- Banks subject to the Expanded Risk-Based Approach would also see substantial capital charges for operational risk, which would apply to interest and fee income generated from retail exposures, including credit card loans and auto leases. Moreover, as pointed out in a BPI recent research note, the agencies' estimate of the increase in funding costs for lending activities as a result of the proposal omits \$1 trillion in RWAs from the operational risk component of the proposal, a substantial proportion of which is likely related to lending activities.<sup>121</sup> This omission means that the agencies' estimate of the impact on funding costs for lending activities is understated by up to a factor of almost four.<sup>122</sup>
- Banks subject to the proposal also face additional, non-capital requirements that broadly increase their funding costs relative to the funding costs of smaller banks, such as liquidity requirements (the Regulation YY liquidity buffer and, for some banks, liquidity coverage ratio and net stable funding ratio requirements), current or proposed LTD requirements and, for some banks, TLAC requirements.

As with residential real estate exposures discussed below, unjustifiably high risk weights for retail exposures, including credit card and auto loans, would adversely affect the cost and availability of credit for retail customers, with adverse implications for household financial inclusion. Of greatest concern are the potential impacts on the credit card market, due to the relatively large increase in effective risk weights for credit cards, and the singular importance of credit cards for financial inclusion: Individuals with limited or no credit record may find it more difficult to obtain affordably priced credit cards, which for many is a first step toward building a credit history.

Furthermore, the proposed rule's introduction of a capital charge on the unused portion of credit card lines could cause banks to close rarely used accounts or to decrease credit limits on low-utilization accounts, as it would become significantly more costly for them to provide such credit lines. This could be especially detrimental to financially vulnerable households that require access to these lines should they face an unanticipated cash shortfall. Federal Reserve survey data indicate that credit cards are the first line of defense for households facing an unanticipated cash shortfall.<sup>123</sup> Also, if banks are pushed to reduce credit limits or close low-utilization accounts, the credit scores of the affected consumers will immediately suffer, impeding their access to credit. Reducing credit limits could have a variety of other implications for consumers across the credit spectrum. For example, credit utilization rates are among the factors that determine a consumer's credit score. Reduced credit limits would likely result in higher utilization rates, which could, in turn, cause credit scores to go down and credit to become more expensive. There is no indication that the agencies considered this or other potential knock-on consequences of the substantial revisions to the capital treatment of consumer credit products.

In addition, a likely consequence of imposing an excessive capital charge on the other retail credit categories would be to constrain the growth of bank lending. Particularly for small-dollar personal loans, this poses financial inclusion concerns, as the agencies have established principles governing such

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<sup>121</sup> See Covas, *supra* note 27, and attached as Appendix 8.

<sup>122</sup> *Id.*

<sup>123</sup> See Board of Governors of the Federal Reserve System, "Report on the Economic Well-Being of U.S. Households in 2022," (May 2023), available at <https://www.federalreserve.gov/publications/files/2022-report-economic-well-being-us-households-202305.pdf>.

lending<sup>124</sup> to encourage it as a safer, more affordable alternative to high-cost consumer credit from non-banks. Banks have been expanding their offering of such products, and unnecessarily high capital requirements would impede this development. The excessive operational risk capital charge affecting auto leases likewise may lead to increased cost of auto loans for consumers.<sup>125</sup>

In sum, the proposed risk weights for retail exposures are unjustifiably high and likely to increase the cost and reduce the availability of credit for retail customers. The proposal does not provide sufficient justification for the calibration of these risk weights or this departure from the Basel framework, especially when weighed against the potential effects on the cost and availability of credit for retail borrowers. Accordingly, the agencies should redevelop risk weights for retail exposures, particularly credit card and auto loans, based on a risk-based, empirical analysis such as the Advanced Approaches calculation.

2. The requirement that a corporate entity have a publicly traded security outstanding in order for an exposure to qualify for a lower risk weight is arbitrary.

The proposed risk weights for corporate loans, as outlined in Section 111(h) of the proposed rule, significantly exceed reliable industry benchmarks based on historical loss experience for this exposure category. From 2014 to 2022, according to the FFIEC 101 reports, the average risk weight for corporate loans across U.S. banks using the Advanced Approaches was 40.6 percent. This average risk weight includes loans across the entire credit risk spectrum.

In contrast, the proposal, with no analytical basis, generally assigns corporate loans a risk weight of 100 percent or a risk weight of 65 percent for a loan (1) that is rated as investment grade by the bank, and (2) where the issuer or the parent of the issuer has a security listed on a public exchange. In effect then, the proposal would arbitrarily impose a 100 percent risk weight on loans to tens of thousands of creditworthy small and mid-sized businesses and to thousands of highly regulated investment funds, such as mutual funds regulated under the Investment Company Act of 1940 ("1940 Act") and pension funds, that would otherwise be investment grade, potentially increasing their cost of credit or limiting its availability. According to a quantitative impact study involving ABA and BPI members ("Member QIS"), this restriction of the investment grade risk weight due to the securities listing requirement leads to an unnecessary 3.3 percent over-calibration of RWAs, on average.<sup>126</sup> In addition, these loans would factor into the interest and services components of the operational risk framework, resulting in an effective risk weight for investment grade corporate exposures that is even higher than the risk weights under the current Standardized Approach.

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<sup>124</sup> See Board of Governors of the Federal Reserve, et al., "Small-Dollar Lending: Interagency Lending Principles for Offering Responsible Small-Dollar Loans," (May 2020), available at <https://www.occ.gov/news-issuances/news-releases/2020/nr-ia-2020-65a.pdf>; Consumer Financial Protection Bureau, "Consumer Financial Protection Bureau Issues No Action Letter to Facilitate Consumer Access to Small-Dollar Loans," (Nov. 5, 2020), available at <https://www.consumerfinance.gov/about-us/newsroom/consumer-financial-protection-bureau-issues-no-action-letter-facilitate-consumer-access-small-dollar-loans/>.

<sup>125</sup> See Calem and Covas, *Retail Lending*, *supra* note 8, and attached as Appendix 2.

<sup>126</sup> This corresponds to the decrease in RWAs resulting from the elimination of the securities listing requirement, relative to the RWAs under the Expanded Risk-Based Approach. For a description of the study, including the study population and methodology, see Appendix 16.

A study using Federal Reserve data shows that banks subject to stress testing lend to 155,589 unique U.S. corporations. Of these, 153,000 are private, with only 2,589 being publicly listed.<sup>127</sup> Based on this sample, the overwhelming majority of U.S. corporations would not be able to satisfy the securities listing requirement and would be subject to a 100 percent risk weight even if they are investment grade. Further, according to another study, regulated investment funds, such as mutual funds and pension plans that do not, in the normal course of their operations, list securities on an exchange are more likely to qualify as investment grade based purely on creditworthiness.<sup>128</sup> This reflects their specific legal and regulatory structure, including detailed asset quality, asset coverage and asset diversification mandates, as well as robust valuation and investor disclosure requirements. Thus, the securities listing requirement makes the Expanded Risk-Based Approach less risk-sensitive because it arbitrarily excludes from the lower 65 percent risk weight a substantial number of corporate entities that should, by any objective measure, qualify for treatment as investment grade.

The proposal includes no analytical basis for the use of the securities listing requirement. In fact, two researchers (one from BPI) using a robust data set have demonstrated that the listing requirement does not result in more consistent ratings or reduced credit risk.<sup>129</sup> That research employed a data set comprising more than 36,000 observations of the probability of default for 12,342 unique corporate entities. It found banks' investment grade rating assignments to the same corporate entity are generally consistent regardless of whether the corporate entity is or is not publicly listed. Consistency of ratings is especially high for investment fund exposures. The securities listing requirement is therefore unnecessary for banks to properly assess their credit risk to corporate entities, in particular to regulated investment funds.

The securities listing requirement would drastically and unnecessarily constrain the number of corporate entities eligible for the reduced 65 percent risk weight, despite the fact that many have similar, if not better, credit risk profiles than companies that would qualify. Certain corporate entities, in particular regulated funds, have good reasons (including in some cases structural and legal considerations) not to operate as public companies, yet are important to economic growth and the ability of Americans to save for retirement and other life events. The securities listing requirement would result in higher costs for these entities, which would have downstream impacts on consumers. Consumers save and invest through mutual funds and pension funds, but higher costs for these funds would result in lower returns on savings and investments, especially over the long term. For unlisted companies, higher cost would result in higher prices paid by consumers for those companies' goods and services.

Likely for these reasons, other jurisdictions, including the EU and UK, have not included a securities listing requirement in their proposed implementation of the Basel standards,<sup>130</sup> compounding the benefit

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<sup>127</sup> See Cecilia Caglio, Mathew Darst and Sebnem Kalemli-Ozcan, *Risk-Taking and Monetary Policy Transmission: Evidence from Loans to SMEs and Large Firms*, Nat'l Bureau of Econ. Rsch. (Oct. 2021), available at [https://conference.nber.org/conf\\_papers/f159755.pdf](https://conference.nber.org/conf_papers/f159755.pdf).

<sup>128</sup> See Covas and Stepankova, *supra* note 10, and attached as Appendix 3.

<sup>129</sup> See *id.*

<sup>130</sup> Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, available at <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52021PC0664>; see also Prudential Regulation Authority, *CP16/22 – Implementation of the Basel 3.1 Standards*, 8.24 (Nov. 30, 2022), available at

that banks in those jurisdictions already receive from the ability to use external ratings for the assessment of credit risk. This approach vastly expands the number of entities eligible for the reduced 65 percent risk weight at EU and UK banks. The Director of Prudential Policy at the Bank of England explained this decision, saying, “[i]n the UK context, however, the challenge is that there are material numbers of unrated corporates and the 100 percent risk weight for them is particularly risk-insensitive.”<sup>131</sup> In the EU, legislators have opted not to implement the securities listing requirement, through at least 2032, with banks instead able to rely on internal probability of default calculations for the assessment of credit risk.<sup>132</sup> In Canada, the securities listing requirement does not apply if a borrower’s annual sales are greater than CAD 75 million and banks are able to access on a regular basis information on the corporate entity to complete due diligence analyses as described in the rule (*e.g.*, annual reports, audited financial statements, quarterly financial statements, and business plans projecting the activities and financial condition for the next 12 months).<sup>133</sup>

According to the proposal, part of the reason for including the securities listing requirement is that “publicly-traded corporate entities are subject to enhanced transparency and market discipline as a result of being listed publicly on an exchange.”<sup>134</sup> But of course banks demand financial statements before lending to privately held companies and also in many cases know the senior management well. Similarly, and as previously noted, regulated investment funds are subject to robust transparency obligations that meet, if not exceed, the standards which apply to publicly listed companies. There is therefore no objective reason to believe that a corporate entity having a listed security would better reflect the probability of default on a loan than a bank’s underwriting process. Indeed, public company requirements under the Securities Exchange Act of 1934 and securities exchange listing standards primarily focus on disclosure and not on creditworthiness. And there is no empirical evidence to suggest that publicly listed companies are any more creditworthy than unlisted companies or regulated investment funds, all else being equal. As noted above, there is considerable evidence to suggest the contrary – none of which is addressed in the proposal.

The proposal also notes that the agencies included the securities listing requirement to provide a “simple, objective criterion that would provide a degree of consistency across banks.”<sup>135</sup> However, there is no empirical evidence to suggest that the securities listing requirement enhances the consistency of investment grade and non-investment grade ratings – and consequently risk weights – across banks that

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<https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards>.

<sup>131</sup> Bank of England, “Implementing Basel 3.1 in the UK – speech by Phil Evans,” (Dec. 7, 2022), *available at* <https://www.bankofengland.co.uk/speech/2022/december/phil-evans-speech-at-uk-finance-on-basel-3-1-consultation>.

<sup>132</sup> Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, *available at* <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=celex%3A52021PC0664>.

<sup>133</sup> See Office of the Superintendent of Financial Institutions, “Capital Adequacy Requirements (CAR) Chapter 4 – Credit Risk—Standardized Approach,” (Jan. 31, 2022), *available at* [https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR22\\_chpt4.aspx](https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/CAR22_chpt4.aspx).

<sup>134</sup> 88 Fed. Reg. at 64,054.

<sup>135</sup> *Id.*

lend to the same entity.<sup>136</sup> Rather, the research cited above found, based on a sample of entities rated by 12 banks, that those banks reached different conclusions on the investment grade determination for a given entity just eight percent of the time, and the difference between the most conservative average risk weights and the most optimistic average risk weights was slightly higher for public entities than private entities (although the difference between the two values is not statistically significant at the five percent level).<sup>137</sup> Therefore, the securities listing requirement is not necessary to promote consistency in banks' investment grade analyses, given the high level of consistency in those ratings.

Contrary to the agencies' justification, the securities listing requirement is both too simple and can produce highly inconsistent outcomes. The corporate risk weight applies to a wide variety of entities, including privately held corporates, mutual funds, pension funds, real estate companies, bank holding companies, insurance companies and other regulated financial institutions that are not insured depository institutions or foreign banks. These entities have a wide variety of business models, many of which do not include publicly listed securities, and the investment grade criteria must apply to all of them. The securities listing requirement is not flexible enough to accommodate the variety of entities that should be eligible for the risk weight applicable to investment grade corporates. In addition, also as a result of the variety of entities subject to the corporate risk weights, the securities listing requirement can result in different treatment for largely similar entities. For instance, while an investment grade exchange-traded fund that tracks the S&P 500 would be eligible for the 65 percent risk weight in view of its status as a listed security, this would not be true of an otherwise investment grade traditional mutual fund with the exact same investment mandate.

For the reasons described above, the agencies should eliminate the securities listing requirement and allow banks to rely on their own internal assessments of credit risk (which we note are subject to supervisory review) to determine whether corporate exposures merit the reduced 65 percent risk weight for investment grade exposures.<sup>138</sup> Doing so would improve the risk-sensitivity of the Expanded Risk-Based Approach by eliminating an arbitrary restriction, unrelated to creditworthiness, on the types of entities the exposures to which can qualify. In addition, eliminating this requirement would be in line with the general acknowledgement in other jurisdictions that the scope of the 65 percent risk weight for investment grade corporate exposures is too narrow under the Basel framework.

Although the limitation on the availability of the investment grade risk weight should be abandoned altogether, at a minimum, the agencies should consider whether to include alternative means of allowing unlisted companies to qualify for the lower risk weight applicable to investment grade exposures. For example, the Expanded Risk-Based Approach could provide that an exposure to an investment grade company would qualify for the 65 percent risk weight if:

- The company or its parent has publicly listed securities;
- The company is a highly regulated entity;<sup>139</sup> or

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<sup>136</sup> See Covas and Stepankova, *supra* note 10, and attached as Appendix 3.

<sup>137</sup> See Covas and Stepankova, *supra* note 10, and attached as Appendix 3.

<sup>138</sup> The agencies allow banks to rely on their own investment grade determinations in other contexts, including the OCC's investment securities regulations. See *generally* 12 C.F.R. Part 1.

<sup>139</sup> We note the agencies' request for comments on applying a lower risk weight to highly regulated entities in

- The company satisfies the informational requirements described below.

For these purposes, there are a variety of entities that should be considered highly regulated.<sup>140</sup> First, regulated investment funds, such as mutual funds registered under the 1940 Act, business development companies regulated under the 1940 Act, pension funds such as employee benefit plans and government plans (as defined in the Employee Retirement Income and Security Act of 1974), and foreign equivalents (such as UCITS in the case of 1940 Act funds), should all qualify for the 65 percent risk weight under the second option above. Regulated investment funds are subject to regulatory requirements relating to leverage and asset quality that decrease their credit risk and disclosure requirements that increase transparency.

Second, highly regulated entities such as investment advisors, insurance companies, broker-dealers, swap dealers, security-based swap dealers and foreign equivalents should likewise qualify for the 65 percent risk weight. These entities are also subject to capital requirements and reporting requirements that increase transparency, such as annual financial statement filings for insurance companies and FOCUS reports for broker-dealers.

For a corporate exposure to qualify under the third prong, a bank should have access to the entity's audited financial statements, unaudited interim financial statements and, where relevant, the fund's prospectus. This information is similar to that provided by publicly listed companies and therefore should result in similar transparency. The addition of these alternative means of qualifying for the 65 percent risk weight would provide for simple, objective criteria to use in the investment grade analysis while avoiding penalizing smaller firms and highly regulated entities for factors unrelated to credit risk. Ultimately, however, the addition of these alternative means of qualifying for the investment grade risk weight does not address the arbitrary nature of the securities listing requirement and the inaccuracy of its underlying premise, and the requirement should be abandoned altogether.

3. Small or medium-sized entity general corporate exposures should be subject to a separate risk weight.

Most general corporate exposures to an SME would default to a 100 percent risk weight under the proposal unless they qualify as investment grade (and the obligor or its parent has listed securities) or as a regulatory retail exposure. The public FFIEC 101 disclosures do not provide the relevant risk weight for small businesses, and the agencies have produced no data to support a 100 percent risk weight. The Basel framework provides for an 85 percent risk weight for SME general corporate exposures. Unless the agencies can produce empirical analysis to demonstrate that a higher risk weight is warranted, the agencies should include a separate 85 percent risk weight category for corporate exposures to SMEs.

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Question 39: "For what reasons, if any, should the agencies consider applying a lower risk weight than 100 percent to exposures to companies that are not publicly traded but are companies that are "highly regulated?" What, if any, criteria should the agencies consider to identify companies that are "highly regulated?" Alternatively, what are the advantages and disadvantages of assigning lower risk weights to highly regulated entities (such as open-ended mutual funds, mutual insurance companies, pension funds, or registered investment companies)?" See 88 Fed. Reg. at 64,054.

<sup>140</sup> In Section IV.A.6, we also recommend that exposures to certain regulated financial entities should be treated as exposures to banks. The agencies could implement either of these recommendations to improve the risk-sensitivity of the Expanded Risk-Based Approach with respect to such regulated financial entities.

Similar to credit cards, small business loans also are subject to steep stress capital add-ons in the stress tests. For instance, Covas estimates that stress tests effectively double the capital requirement for small business loans.<sup>141</sup> The stakes are significant. Academic research has demonstrated that stress tests have reduced the availability of credit to small businesses in the United States. For instance, Acharya, Berger and Roman find that banks subject to the stress tests have reduced the supply of credit to borrowers that could be perceived as carrying higher credit risk, such as small businesses. Also, Cortés, Demyanyk, Li, Loutskina and Strahan find that banks most affected by the stress tests reduced their supply of business loans by increasing loan rates and shifting their portfolios towards loans perceived to have less credit risk.<sup>142</sup> The proposal could similarly result in reduced availability of credit for small businesses without any evidence that loans to small businesses are undercapitalized.

Additionally, small business loans would also attract an operational risk capital charge. These loans generate interest income and fees from lines of credit, which would affect the interest and services component of the operational risk charge. This would result in an even higher overall capital charge for small business loans.

Therefore, implementing an 85 percent risk weight for SMEs would mitigate undue increases in capital requirements for lending activities involving SMEs, which may already face challenges in obtaining credit, as demonstrated by the research cited above.

4. The agencies should include a separate risk weight for highly capitalized banks.

The risk weight applicable to exposures to banks<sup>143</sup> would be 40 percent under the proposal.<sup>144</sup> From 2014 to 2022, according to the FFIEC 101 reports, U.S. banks utilizing the Advanced Approaches assigned an average risk weight of 30.3 percent to loans to banks of all “grades” under the proposal and across all tenors of loans. There are numerous criteria by which bank credits could be differentiated. The Basel framework provides for a lower risk weight for certain Grade A banks. However, the agencies did not reflect this aspect of the framework in the proposal, and they offer no analysis or justification for why there should not be further risk-sensitivity by distinguishing among Grade A banks.

The Expanded Risk-Based Approach is meant to be more risk-sensitive than the Standardized Approach, yet the lowest risk weight applicable to banks under the Expanded Risk-Based Approach would be 40 percent. To be truly risk-sensitive, the Expanded Risk-Based Approach should have risk weights for banks that start lower than those under the generally applicable Standardized Approach and increase based on measures of risk, such as the Grade A, B and C criteria or other, more granular criteria, such as the Basel framework’s differentiation between certain Grade A exposures.

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<sup>141</sup> See Francisco Covas, *Capital Requirements in Supervisory Stress Tests and Their Adverse Impact on Small Business Lending*, The Clearing House (Sept. 25, 2018), available at [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3071917](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3071917).

<sup>142</sup> See Kristle R. Cortés, et al., *Stress tests and small business lending*, J. Fin. Econ., Vol. 136, Issue 1, 260, 279 (April 1, 2020), available at <https://doi.org/10.1016/j.jfineco.2019.08.008>.

<sup>143</sup> In this Section IV.A.4, and in Sections IV.A.5 and IV.A.6, “bank” refers to a depository institution, foreign bank or credit union; *i.e.*, the entities an exposure to which would be considered a “bank exposure” under the proposal. See § \_\_.101.

<sup>144</sup> Basel framework, 20.21, note 15.

Including a 40 percent risk weight as the lowest possible risk weight for exposures to banks also would put U.S. banks at a competitive disadvantage compared to banks that are subject to the external credit ratings approach in the Basel framework. Under the external credit ratings approach, exposures to banks rated A- or higher would receive a lower risk weight than the minimum risk weight that would be possible under the proposal. Many banks, including many in the United States, have credit ratings within that range, and therefore, compared to U.S. banks, non-U.S. banks would have lower capital requirements for exposures to highly rated banks.

The Expanded Risk-Based Approach should therefore include a 20 percent risk weight for exposures to certain banks that pose the least amount of credit risk. This would facilitate large banks' provision of credit to small banks, which they use to support their local communities. This would also be important for the cost and availability of derivatives for commercial end users to hedge their business risks because banks usually hedge these exposures through transactions with other banks. It would also improve the risk-sensitivity of the Expanded Risk-Based Approach and the coherence of the overall capital framework, as well as avoid putting U.S. banks at a competitive disadvantage.

In addition, the expectations regarding how banks would determine whether a foreign bank is subject to capital standards consistent with the Basel framework should be clarified. In order to determine whether an exposure to a foreign bank is a Grade A, Grade B or Grade C bank exposure, the proposal would require banks to determine, among other things, whether the foreign capital standards imposed by the home country supervisor of the foreign bank are consistent with the Basel framework.<sup>145</sup> The proposal does not elaborate upon what would make foreign capital standards "consistent" with the Basel framework. The agencies should revise the definitions of Grade A bank exposure and Grade B bank exposure to provide that a foreign bank must be subject to capital standards *broadly* consistent with the Basel framework. This change would facilitate efficient implementation of the Grade A, Grade B or Grade C framework as it would make clear that banks should focus on material aspects of the capital framework (*e.g.*, the components of capital consisting of CET1, Tier 1 and Total capital and whether the ratio requirements align with the Basel framework), as opposed to a detailed provision-by-provision review of foreign regulatory regimes.

5. Short-dated exposures to banks should receive lower risk weights.

The proposal would apply the same risk weights in Table 2 of Section 111 to all exposures to banks, including those with a maturity date of less than three months.<sup>146</sup> This undifferentiated treatment conflicts with the purported goal of making the capital framework more risk-sensitive. Indeed, the risk weights in the proposal are up to 25 percentage points higher (depending on the grade of the exposure) than the risk weights applicable to short-dated exposures under the Basel framework. The proposal does not provide any justification for this treatment, and the agencies provide no data or analysis, for departing from the already excessive approach prescribed in the Basel framework. The agencies should conduct a rigorous analysis of the relative performance of exposures by maturity date, which we presume would yield lower risk weights for short-term exposures to banks.

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<sup>145</sup> See the definitions of "Grade A bank exposure" and "Grade B bank exposure" in § \_\_.101.

<sup>146</sup> We acknowledge that the proposal would provide lower risk weights for foreign bank exposures that are self-liquidating, trade-related contingent items that arise from the movement of goods and that have a maturity of three months or less. See § \_\_.111(d)(2)(iii).

Doing so would improve the risk-sensitivity of the Expanded Risk-Based Approach by recognizing the lower credit risk posed by short-dated bank exposures as compared to longer-dated bank exposures. This is particularly important in the context of the elimination of the Advanced Approaches where the recognition of maturity is embedded in the risk weight determination. Short-dated bank-to-bank exposures are key to providing intra-bank liquidity, and the proposal's higher risk weights would needlessly increase the capital charges for these exposures, impairing a key source of liquidity for the financial markets. According to the Member QIS, simply aligning the short-dated bank exposure risk weights with those of the Basel framework, which may still be too high, would reduce the over-calibration of RWAs by 0.5 percent, on average.<sup>147</sup>

6. An exposure to a securities firm or other financial institution should be treated as an exposure to a bank so long as the financial institution is subject to bank prudential standards and supervision.

The Basel framework permits exposures to securities firms and other financial institutions to be treated as exposures to banks if the securities firms or other financial institutions are subject to prudential standards and a level of supervision equivalent to those applied to banks, reflecting the fact that compliance with prudential requirements generally decreases an institution's risk.<sup>148</sup> This aspect of the Basel framework was not reflected in the proposal. Rather, exposures to securities firms and other financial institutions would generally be treated as corporate exposures and subject to the risk weights in Section 111(h).

Absent data or analysis to suggest otherwise (not included in the proposal), an exposure to a broker-dealer, swap dealer or foreign equivalent that is itself directly subject to Basel-based bank capital requirements should be treated as an exposure to a bank, qualifying for the lower risk weights applicable to banks, under both the Expanded Risk-Based Approach and Standardized Approach.<sup>149</sup> First, exposures to UK or EU investment firms subject to the UK or EU bank capital and liquidity requirements should be treated as exposures to banks. Under the rules of those jurisdictions, certain investment firms are subject to the same Basel-based prudential capital and liquidity requirements as banks, and all investment firms are subject to capital requirements in general.<sup>150</sup> Second, non-bank swap dealers that have elected to be subject to the prudential capital framework under Part 217<sup>151</sup> should likewise be treated as exposures to banks because they are directly subject to comprehensive supervision and to bank prudential standards in

<sup>147</sup> This corresponds to the decrease in RWAs resulting from the alignment of short-dated bank exposure risk weights with those of the Basel framework, relative to the RWAs under the Expanded Risk-Based Approach. For a description of the study, including the study population and methodology, see Appendix 16.

<sup>148</sup> Basel framework, 20.16.

<sup>149</sup> In Section IV.A.2, we also recommend that exposures to certain regulated entities should be treated as investment grade exposures, regardless of whether they or their parents have listed securities. The agencies could implement either of these recommendations to improve the risk-sensitivity of the Expanded Risk-Based Approach with respect to such regulated financial entities.

<sup>150</sup> See European Commission, "Prudential rules for investment firms," (June 24, 2021), available at [https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/financial-markets/prudential-rules-investment-firms\\_en](https://finance.ec.europa.eu/capital-markets-union-and-financial-markets/financial-markets/prudential-rules-investment-firms_en); see also Prudential Regulation Authority, *Implementation of Basel Standards*, Bank of England (July 2021), available at <https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2021/july/ps1721.pdf>.

<sup>151</sup> See 17 C.F.R. § 23.101(a)(1)(i).

the form of capital requirements. Third, exposures to broker-dealers that are subject to bank supervision and prudential requirements by virtue of being subsidiaries of bank holding companies or savings and loan holding companies should be treated as bank exposures. The agencies have in the past recognized that such broker-dealers “generally pose relatively low credit risk” to banks and that this merited a reduction in the risk weight applicable to claims on U.S. broker-dealers from 100 percent to 20 percent.<sup>152</sup> Moreover, U.S. bank holding companies are generally subject to the same capital and liquidity requirements applicable to banks, and, in some cases, are subject to more stringent requirements, such as the SCB and Regulation YY liquidity stress testing and buffer requirements.<sup>153</sup> The risk weights applicable to banks should likewise apply to U.S. bank holding companies.

Reflecting this aspect of the Basel framework in the Expanded Risk-Based Approach and Standardized Approach would improve the risk-sensitivity of the U.S. capital framework by recognizing that these financial institutions pose less credit risk than general corporate exposures as a result of compliance with prudential standards and the supervision to which they are subject. This change would also achieve greater alignment with international standards.

7. High-quality project finance exposures should receive an 80 percent risk weight during the operational phase.

The proposal would introduce a new treatment of project finance exposures, applying a 130 percent risk weight during the pre-operational phase and a 100 percent risk weight during the operational phase. The proposal contains no data to support either risk weight, let alone a heightened risk weight during the pre-operational phase.<sup>154</sup>

Moreover, unlike the Basel standard, the proposal would not provide a lower risk weight for high-quality project finance exposures during the operational phase.<sup>155</sup> Under the Basel framework, a high-quality project finance exposure is an exposure to a project finance entity that is able to meet its financial commitments in a timely manner. This ability must be robust even against adverse changes in the economic cycle and business conditions. In addition, high-quality project finance exposures must meet other conditions, such as certain protections for creditors in case of the project finance entity’s default.<sup>156</sup> These conditions provide protection from credit risk that other project finance exposures do not have. The agencies should therefore include an 80 percent risk weight for high-quality project finance exposures during their operational phase. This is supported by default studies that show that investment grade

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<sup>152</sup> 67 Fed. Reg. 16,971, 16,975 (Apr. 9, 2002).

<sup>153</sup> The same is true for U.S. savings and loan holding companies. *See generally* 12 CFR Part 238, subparts N-R.

<sup>154</sup> The proposal simply states, in a conclusory manner, that “Relative to the operational phase, the pre-operational phase presents increased uncertainty that the project will be completed in a timely and cost-effective manner, which warrants the application of a higher risk weight. For example, market conditions could change significantly between commencement and completion of the project. In addition, unanticipated supply shortages could disrupt timely completion of the project and the expected timing of the transition to the operational phase. These unanticipated changes could disrupt the completion of the project and delay it becoming operational, and thus impact the ability of the project to generate cash flows as projected and to repay creditors.” 88 Fed. Reg. at 64,055. The proposal does not provide data to support either the 100 or 130 percent risk weights.

<sup>155</sup> *See* Basel framework, 20.51.

<sup>156</sup> *See* Basel framework, 20.52.

project finance exposures demonstrate lower default rates than investment grade corporate infrastructure exposures, excluding utilities.<sup>157</sup> In this context, the 80 percent risk weight would be conservative compared to the 65 percent risk weight applicable to investment grade corporate issuers. This change would improve the risk-sensitivity of the Expanded Risk-Based Approach and also align the U.S. capital framework with international standards.

8. The proposed definition of real estate exposures dependent on cash flows generated by the real estate should be narrowed.

Under the proposal, banks must apply higher risk weights to real estate exposures that are dependent on the cash flows generated by the real estate as compared to real estate exposures that are not. Section 101 of the proposal defines “dependent on the cash flows generated by the real estate” as “for a real estate exposure, for which the underwriting, at the time of origination, includes the cash flows generated by lease, rental, or sale of the real estate securing the loan as a source of repayment.” The definition excludes residential real estate exposures secured by the borrower’s principal residence. The preamble explains that “[i]f the underwriting process at origination of the real estate exposure considers *any* cash flows generated by the real estate securing the loan, such as from lease or rental payments or from the sale of the real estate as a source of repayment, then the exposure would meet the proposal’s definition of dependent on the cash flows generated by the real estate.”<sup>158</sup>

The proposal includes no historical data to support this distinction or the higher risk weight in general. It also conflicts with the Basel framework, which applies higher risk weights to real estate exposures that are *materially* dependent on the cash flows generated by the real estate. The Basel framework notes that an exposure is materially dependent on the cash flows of the real estate “when the prospects for servicing the loan materially depend on the cash flows generated by the property securing the loan rather than on the underlying capacity of the borrower to service the debt from other sources.”<sup>159</sup> As an example, the Basel framework notes that “a loan may be considered materially dependent if more than 50 percent of the income from the borrower used in the bank’s assessment of its ability to service the loan is from cash flows generated by the residential property.”<sup>160</sup>

The agencies argue that higher risk weights are appropriate because exposures that are dependent on cash flows from the underlying real estate present higher credit risk because the borrower’s ability to repay the loan may be affected by local market conditions. This is not necessarily true for every loan where cash flows generated by the property are considered to some degree as part of the underwriting process. The Basel framework’s limitation to exposures that *materially* depend on cash flows from the property would better identify exposures that present this elevated credit risk. For example, a residential real estate loan (not secured by the borrower’s personal residence) with respect to which a bank determined during the underwriting process that 10 percent of the borrower’s income available to service the loan would come from cash flows generated by the underlying property does not merit the 10 to 35

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<sup>157</sup> See table 3 in the S&P study “Default, Transition, and Recovery: 2022 Annual Infrastructure Default and Rating Transition Study,” S&P Global Ratings (April 20, 2023) *available at* <https://www.spglobal.com/ratings/en/research/articles/230420-default-transition-and-recovery-2022-annual-global-structured-finance-default-and-rating-transition-study-12685128>.

<sup>158</sup> 88 Fed. Reg. at 64,046 (emphasis added).

<sup>159</sup> Basel framework, 20.79.

<sup>160</sup> *Id.* at 20.80.

percentage point higher risk weight (depending on the exposure's LTV ratio) it would receive under the proposal. As compared to the Basel framework, this loan would receive a 30 to 55 percentage point higher risk weight, given the 20 percentage point increase in the proposal's risk weights as compared to those of the Basel framework.<sup>161</sup>

The proposal notes that “[e]valuating whether repayment of the exposure is dependent on cash flows generated from the real estate is a conservative and straightforward approach for differentiating the credit risk of real estate exposures.”<sup>162</sup> The proposal adopts an overly conservative approach in this and other respects, presumably because of high losses experienced on real estate loans in the past. However, post-Global Financial Crisis, banks apply more rigorous standards in underwriting and monitoring real estate loans. The Basel framework's method of determining whether an exposure is materially dependent on cash flows from the property (*i.e.*, whether more than 50 percent of the borrower's income used in the underwriting process is from cash flows generated by the residential property) is likewise straightforward and conservative, without being ultra-conservative. However, it is also more risk-sensitive.

In addition, the Basel framework lists several types of real estate exposures that are not considered exposures materially dependent on cash flows from the property: (1) an exposure secured by a property that is the borrower's primary residence; (2) an exposure secured by an income-producing residential housing unit, to an individual who has mortgaged fewer than a certain number of properties or housing units, as specified by national supervisors; (3) an exposure secured by residential real estate property to associations or cooperatives of individuals that are regulated under national law and exist with the only purpose of granting its members the use of a primary residence in the property securing the loans; and (4) an exposure secured by residential real estate property to public housing companies and not-for-profit associations regulated under national law that exist to serve social purposes and to offer tenants long-term housing.<sup>163</sup> The agencies included the first of these exceptions in the proposal,<sup>164</sup> but without explanation excluded the others. In our experience, they are each accurate reflections of risk and therefore should be included.

9. The risk weights for residential real estate exposures are not based on an empirical assessment of risk and significantly overstate risk.

The proposed risk weights for residential real estate exposures, as outlined in Table 5 of Section 111 of the proposed rule, significantly exceed reliable benchmarks based on historical loss experience for this exposure category. They exceed the risk weights from the empirically supported Advanced Approaches calculation by more than double. They are also 20 percentage points above the corresponding risk weights in the Basel framework.<sup>165</sup> According to the Member QIS, this surcharge above the Basel risk

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<sup>161</sup> See Section IV.A.9 below for our recommendations regarding these proposed risk weights.

<sup>162</sup> 88 Fed. Reg. at 64,046.

<sup>163</sup> Basel framework, 20.81.

<sup>164</sup> See § \_\_.101.

<sup>165</sup> See Basel framework, 20.82. As FDIC Director McKernan notes in his statement dissenting from the proposal, the risk weights in the Basel framework are better aligned with the risk posed by residential real estate exposures, as demonstrated in a proposal and analysis submitted by U.S. bank regulators to the Basel Committee when the Basel framework was being developed. See Statement by Jonathan McKernan, Member, FDIC Board of Directors, on the Proposed Amendments to the Capital Framework (July 27, 2023),

weights for mortgage exposures alone leads to an unnecessary 1.9 percent over-calibration of RWAs, on average.<sup>166</sup> The proposal offers no analytical foundation for these risk weights and provides no risk-based explanation for the upward deviation from the Basel framework (only noting briefly that higher risk weights for large banks would boost the competitiveness of small banks, which is not the proper purpose of capital requirements).

The proposal also largely neglects the potential impacts of these higher risk weights on the cost and availability of mortgage loans, offering only some broad comments that do not suffice to allay serious concerns about potential impacts on mortgage lending in particular.<sup>167</sup> In particular, the proposal would accelerate the continued migration of mortgage origination to non-banks, which have been found to charge borrowers steeper origination costs.<sup>168</sup> Non-bank activity in the mortgage market has expanded considerably in the post-crisis period. As shown in Figure 18 below, between 1995 and 2007, banks' market share was stable, consistently around 70 percent of all mortgage originations. According to the most recent data on mortgage loans, banks now account for only about 38 percent of all mortgage loan originations for home purchases. With the proposed changes to mortgage risk weights, aggravated by the additional mortgage-associated operational risk charges both under the Expanded Risk-Based Approach and the SCB, this trend would likely further accelerate.

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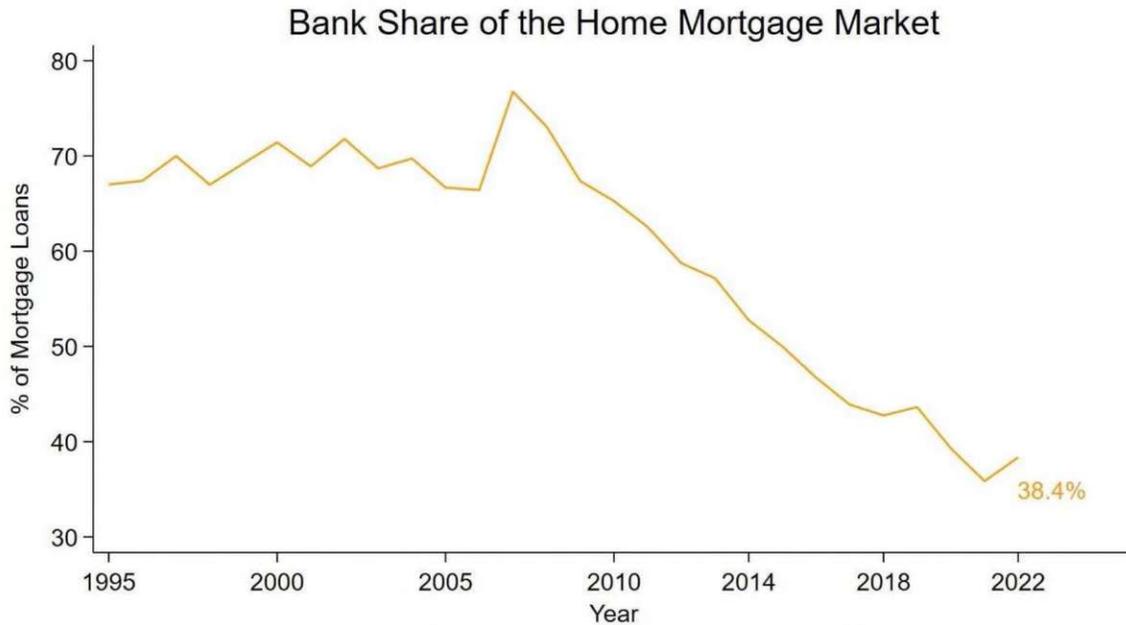
available at <https://www.fdic.gov/news/speeches/2023/spiul2723c.html>.

<sup>166</sup> This corresponds to the decrease in RWAs resulting from the alignment of mortgage risk weights with those of the Basel framework, relative to the RWAs under the Expanded Risk-Based Approach. For a description of the study, including the study population and methodology, see Appendix 16.

<sup>167</sup> Federal Reserve research studies find evidence that stress testing and capital requirements for mortgage credit risk implemented following the Dodd-Frank Act have significantly affected banks' mortgage loan origination activity. See Paul Calem, Ricardo Correa and Seung Jung Lee, *Prudential policies and their impact on credit in the United States*, J. Fin. Intermediation, Vol. 42 (April 1, 2020), available at <https://doi.org/10.1016/j.jfi.2019.04.002>; see also Andrew Haughwout, et al., "Nonconforming Preferences: Jumbo Mortgage Lending and Large Bank Stress Tests," Federal Reserve Bank of New York Staff Report no. 1029, (Sept. 1, 2022), available at [https://www.newyorkfed.org/medialibrary/media/research/staff\\_reports/sr1029.pdf?sc\\_lang=en](https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr1029.pdf?sc_lang=en).

<sup>168</sup> See Ann Choi, et al., *Borrowers Turned to Nonbank Lenders for Mortgages – And It's Costing Them*, Bloomberg (Dec. 18, 2023), available at <https://www.bloomberg.com/graphics/2023-nonbank-lender-mortgage-loan-borrower-fee/> ("[n]onbank borrowers paid 22 percent more on average in origination charges than bank borrowers who bought similarly priced homes, received comparable interest rates and had similar incomes, debt loads and creditworthiness").

Figure 18



Source: Consumer Financial Protection Bureau (Mortgage originations from HMDA) and FR Y-9C.

We encourage the agencies to calibrate the risk weights for residential real estate exposures based on empirical analysis of the risk posed by these exposures. We believe this would invariably place them below the Basel framework’s risk weights, which itself is already a conservative calibration. Such an approach would be more risk-sensitive and promote better access to credit than the proposed rule, thus mitigating adverse impacts on housing finance and credit availability.

From 2014 to 2022, according to the FFIEC 101 reports,<sup>169</sup> the average risk weight for all first-lien residential loans across U.S. banks using the Advanced Approaches was about 25 percent. The agencies have reviewed and approved banks’ internal risk parameter estimates that produced this outcome. They have not demonstrated that this approach produces inaccurate outcomes. By design, the Advanced Approaches risk weights are sufficient to absorb losses during severe downturns. Thus, these risk weights are presumably both reliable and accurate. The proposal does not support its suggestions to the contrary with any empirical analysis. Notably, the Basel framework, as adopted by other jurisdictions, allows banks to utilize the Advanced Approaches, subject to a floor set by the standardized approach.

A study by the Urban Institute further demonstrates that the proposal’s mortgage risk weights are significantly overstated in relation to historical loss experience, using data from the mortgage crisis period.<sup>170</sup> Those researchers examine losses on loans guaranteed by GSEs from 2005 to 2008 (the cohort whose default rates prompted the mortgage crisis) by credit score and LTV range to extrapolate the losses to the current bank mortgage loan portfolio that would occur in a similar stress environment. They estimate an average portfolio loss rate of 2.7 percent, given the data they have on the current credit score and LTV distribution of bank portfolios. The Urban Institute researchers conclude that the proposed risk

<sup>169</sup> See generally Federal Financial Institutions Examination Council, Reporting Forms 101, available at [https://www.ffiec.gov/pdf/FFIEC\\_forms/FFIEC101\\_202309\\_f.pdf](https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC101_202309_f.pdf).

<sup>170</sup> See Laurie Goodman and Jun Zhu, *supra* note 13.

weights are high relative to the loss rates suggested by the worst period in mortgage history.

When applying the hypothetical loss rates from a high-stress period to a sample of home purchase loans originated in 2022 by banks affected by the proposed rule, BPI estimates a portfolio loss rate of 2.9 percent, close to the estimate obtained by the Urban Institute researchers.

Further confirmation is provided by the Federal Reserve’s stress testing loss rates. These vary between 0.7 percent and 3.0 percent (across different FICO ranges) for loans with LTVs below 80 percent, and between 1.8 percent and 6.6 percent for loans with LTVs exceeding 80 percent, which are broadly consistent with BPI’s and the Urban Institute’s estimates.

Moreover, this historical benchmarking likely overstates future loss rates. Per the Urban Institute, the historical loss rates used as benchmarks “overestimate the potential loss rate for the current bank book of business.” Mortgage lending “has become more prudent in ways not directly reflected in FICO scores and LTV ratios.”<sup>171</sup> The proposal considers none of these factors.

The proposal’s brief rationale for diverging from the Basel framework is that more accurate risk weight for banks subject to the Expanded Risk-Based Approach would give them a competitive advantage over smaller banks not subject to the proposed rules.<sup>172</sup> That rationale is faulty for multiple reasons. First, the agencies’ goal in developing a capital framework should be to assign accurate risk weights, not to achieve competitive outcomes.

Second, its premise is clearly false. Applying lower risk weights for mortgages under the Expanded Risk-Based Approach, certainly at the Basel level and even well below, would not put smaller banks at a competitive advantage because larger banks are subject to multiple other capital charges for mortgage lending that smaller banks are not. For example:

- Banks subject to the proposal are subject to the SCB, from which a capital add-on for mortgage lending of about 20 percentage points may reasonably be assumed given the large decline in house prices under stress.<sup>173</sup>
- With the proposed dual-stack framework, larger banks would remain subject to the current Standardized Approach, effectively eliminating banks’ ability to benefit from any instance when a particular exposure would have a lower risk weight under the Expanded Risk-Based Approach.

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<sup>171</sup> See Laurie Goodman and Jun Zhu, *supra* note 13.

<sup>172</sup> See 88 Fed. Reg. at 64,170 (“In addition, the proposal attempts to mitigate potential competitive effects between U.S. banks by adjusting the U.S. implementation of the Basel III reforms, specifically by raising the risk weights for residential real estate and retail credit exposures. Without the adjustment relative to Basel III risk weights in this proposal, marginal funding costs on residential real estate and retail credit exposures for many large banks could have been substantially lower than for smaller organizations not subject to the proposal. Though the larger organizations would have still been subject to higher overall capital requirements, the lower marginal funding costs could have created a competitive disadvantage for smaller firms.”).

<sup>173</sup> See Calem and Covas, *Mortgage Lending*, *supra* note 12, and attached as Appendix 4 (describing the effect of the SCB on average risk weights for residential real estate loans).

- The superficial mention of competitive considerations in the impact analysis completely fails to recognize that residential real estate lending would factor into banks' business indicators and operational risk capital requirements under the Expanded Risk-Based Approach. Thus, larger banks would be hugely disadvantaged, in relation to smaller banks, in regard to the 25 percent of residential real estate loans sold to the GSEs, which would receive particularly high effective risk weights due to operational risk capital requirements.<sup>174</sup> BPI research estimates that the total effective risk weight for a mortgage with an LTV between 80 and 90 percent that was sold to a GSE could be as high as 140 percent for a bank that sells a large volume of mortgages to the GSEs. This high percentage is attributed to the operational risk capital charges associated with the fee income from selling the loan and the balance sheet charges incurred while the loan remains on the balance sheet before its sale.<sup>175</sup> Again, the proposal ignores this fact.
- Banks subject to the proposal have a variety of additional, non-capital requirements that broadly increase their funding costs relative to the funding costs of smaller banks, including liquidity requirements (the Regulation YY liquidity buffer and, for some banks, liquidity coverage ratio and net stable funding ratio requirements), current or proposed LTD requirements and, for some banks, TLAC requirements.
- The agencies proposed to apply the 20 percentage point add-on to the Basel standard to all real estate lending exposures to address these competitive concerns relating to marginal funding costs, without distinguishing whether the loans are held for investment or held for sale, or analyzing whether varying marginal funding costs for exposures held for sale present different issues from loans held for investment.<sup>176</sup>

Aside from the lack of sufficient justification for the departure from the Basel framework, the unjustifiably high risk weights for residential real estate exposures would have significantly adverse consequences for the cost and availability of mortgage credit, in particular for first-time homebuyers and LMI homebuyers. BPI research demonstrates that, under the proposal, the average risk weight for loans to LMI borrowers originated in 2022 would be 57.5 percent; for loans to non-LMI borrowers, it would be 52.6 percent.<sup>177</sup> The average risk weight of loans to Black borrowers is estimated to be 59.6 percent, and more than half of loans to Black borrowers would receive a risk weight of 70 percent or greater, compared with

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<sup>174</sup> See Calem and Covas, *Mortgage Lending*, *supra* note 12, and attached as Appendix 4 (finding that operational risk capital charges would add five percentage points to the risk weight of a mortgage loan retained on a bank's balance sheet, on average, and estimating that operational risk capital charges would double the risk weight for a mortgage loan sold to a GSE); see also Covas, *supra* note 27, and attached as Appendix 8 (explaining that Vice Chair Barr's and the agencies' cost analyses omit \$1 trillion in RWAs due to operational risk and therefore the true estimate of the effect of operational risk on funding costs is up to almost quadruple the agencies' estimate, with a particular impact on mortgage lending costs due to the drastic increase in capital requirements for mortgage lending under the proposal).

<sup>175</sup> See Calem and Covas, *Mortgage Lending*, *supra* note 12, and attached as Appendix 4.

<sup>176</sup> See *id.*

<sup>177</sup> See Calem and Covas, *Mortgage Lending*, *supra* note 12, and attached as Appendix 4.

less than a quarter of those to white borrowers.<sup>178</sup> Higher capital requirements reduce the economic returns for a particular loan, product or activity and could make the loan, product or activity uneconomic.

FDIC Director McKernan pointed to the proposal’s potential harm to LMI homebuyers in his statement dissenting from the proposal, noting that these higher capital requirements could lead to increased interest rates for these borrowers, increasing the obstacles they face on the path to home ownership.<sup>179</sup> The Urban Institute likewise notes that “[r]aising the capital charges on high-LTV loans raises the mortgage interest rates for the remaining borrowers least able to afford the increases.”<sup>180</sup> Increasing capital requirements for mortgages for first-time homebuyers and LMI households would be inconsistent with the general public policy of promoting affordable housing and home ownership and other specific federal initiatives such as a more robust Community Reinvestment Act and promotion of special purpose credit programs for underserved borrowers.<sup>181</sup>

In addition, the agencies did not consider the broader impact of the proposal on housing finance and the housing market, including the impact of Category III and IV banks being required to deduct mortgage servicing assets that individually exceed 10 percent of CET1 capital or that exceed 15 percent of CET1 capital in the aggregate, instead of the 25 percent threshold that currently applies.

For these reasons, the agencies should redevelop risk weights for residential mortgage exposures based on a risk-based, empirical analysis. For example, the Advanced Approaches calculation is empirically based. It aggregates empirically estimated, segment-level, long-run default probabilities for banks into a portfolio risk weight based on a mapping that contains an element of stress. The agencies could use the data from the Advanced Approaches to propose revised risk weights that are demonstrably appropriate given that data.

Finally, regardless of where the risk weights for mortgage land for purposes of Basel implementation, the mortgage component of the Federal Reserve’s stress test and resulting SCB must be revisited. If Basel risk weights are being calibrated for anything like 2005 – 2008 performance, there is no justification for adding a stress charge on top.

10. The treatment of first-lien and second-lien residential mortgage exposures held by the same bank is arbitrary and inconsistent with sound risk management.

Under the current Standardized Approach, a bank that holds both a first-lien and second-lien residential mortgage exposure on the same property (with no intervening liens) must treat the combined exposures as a single first-lien residential mortgage exposure.<sup>182</sup> This treatment generally provides *favorable* capital treatment to the exposures because the second-lien exposure can benefit from the 50 percent risk weight available to first-lien residential mortgage exposures on owner-occupied properties

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<sup>178</sup> See *id.*

<sup>179</sup> See McKernan, *supra* note 165.

<sup>180</sup> See Goodman and Zhu, *supra* note 13.

<sup>181</sup> See Board of Governors of the Federal Reserve, et al., “Interagency Statement on Special Purpose Credit Programs,” (Feb. 22, 2022), available at <https://www.fdic.gov/news/financial-institution-letters/2022/fil22008a.pdf>.

<sup>182</sup> See 12 C.F.R. §§ 3.32(g)(3); 217.32(g)(3); 324.32(g)(3).

that are prudently underwritten.<sup>183</sup>

The proposal would mandate this same treatment for first-lien and second-lien residential exposures held by the same bank on the same property (with no intervening liens) under the Expanded Risk-Based Approach even though this treatment would have the *opposite* effect as under the current Standardized Approach.<sup>184</sup> Specifically, because the risk weight for residential mortgages under the Expanded Risk-Based Approach (unlike the current Standardized Approach) takes into account the LTV ratio, this approach under the proposal would frequently *increase* the risk weight on the first-lien exposure if the same bank provided a second-lien exposure (*e.g.*, a home equity loan or line of credit) on the property, rather than reducing the risk weight on the second-lien exposure. Moreover, because a first-lien mortgage is typically larger than any second-lien on the property, this treatment under the proposal is *more punitive* to the bank holder of the liens than the current Standardized Approach, which would be *favorable* to the same holder. In effect, the second-lien would taint the first-lien under the Expanded Risk-Based Approach.

This anomalous result appears to be a consequence of the agencies' attempt to provide for some consistency between the Expanded Risk-Based Approach and the current Standardized Approach, but the agencies apparently did not fully consider the effects of importing this aspect of the Standardized Approach into the Expanded Risk-Based Approach. The agencies provide no explanation of why the exact same fact pattern should result in *punitive* capital treatment under the proposal while receiving *favorable* capital treatment under the current Standardized Approach. The result under the Standardized Approach recognizes, while the proposed approach fails to, that there are risk management *benefits* when a single bank holds both the first- and second-lien exposures on the same property, such as the bank's ability to coordinate the handling of both liens should the borrower run into financial hardship. The agencies also provide no explanation as to why the punitive capital treatment under the proposal for first- and second-lien residential real estate exposures on the same property would apply only if the same bank holds both liens.<sup>185</sup> This puts the bank holding the first-lien mortgage at a competitive disadvantage to other banks in providing the second-lien loan. Moreover, penalizing those banks that are in the mortgage business and offer both home equity lines of credit ("HELOCs") and mortgage loans will ultimately result in even more of this business being pushed to non-bank lenders.

The agencies should therefore eliminate the requirement to aggregate first- and second-lien exposures if held by the same bank with no intervening liens. Alternatively, the agencies could retain the aggregation requirement but cap the combined RWAs on the two liens at the amount of RWAs that would result if the liens were risk-weighted separately (*i.e.*, the risk weight for the first lien is based only on the LTV for the first lien, and the second lien is risk-weighted as an "other real estate exposure" under Section 111(f)(7), just as it would be if it were held by a different bank).

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<sup>183</sup> See *id.* at § 3.32(g)(1).

<sup>184</sup> See 88 Fed. Reg. at 64045, note 81.

<sup>185</sup> The cumulative LTV of the exposures, for example, does not vary based on whether a single bank holds both exposures or the exposures are held by separate banks.

**B. The treatment of off-balance sheet commitments does not accurately reflect the risk of those exposures.**

1. The CCFs for unconditionally cancellable commitments should be tailored to reflect empirical analysis of how various categories of commitments have performed historically and should in no case be higher than 6.5 percent.

Section 112(b)(1) of the proposal would require banks to calculate the exposure amount of unconditionally cancellable commitments by applying a 10 percent CCF. Under the generally applicable Standardized Approach, unconditionally cancellable commitments are subject to a 0 percent CCF. As noted above, there is no justification for the proposed 10 percent CCF, and available evidence suggests that it should be much lower. For instance, an empirical analysis using data collected by BPI’s predecessor organization in 2016 indicates that the implied CCF for credit cards at Advanced Approaches banks was 6.5 percent, and it estimates an aggregate CCF for credit card loans at three percent.<sup>186</sup> In addition, we have conducted a “reverse engineering” of the CCF implicit in the Advanced Approaches risk weight, based on an estimated regression equation, which suggests an implied CCF of about five percent.<sup>187</sup> Based on this risk-based analysis, the CCFs for unconditionally cancellable commitments should be calibrated to reflect empirical analysis of how various categories of these commitments have performed historically, and should in no case be higher than 6.5 percent.

The fact that the 10 percent CCF was a consensus among countries that are parties to the Basel agreement does not mean that the calibration is necessarily appropriate for U.S. banks. There are huge differences across countries in the number of cards people hold, the extent to which consumers use credit cards for payments, the share of card balances that are revolving and other relevant aspects of card utilization, as overviewed by the UK’s Financial Conduct Authority in 2015.<sup>188</sup> Moreover, in contrast to what the agencies have proposed for the United States, other countries provide banks the option of using the Advanced Approaches, under which CCFs are calibrated based on banks’ internal models, not arbitrarily set at 10 percent.

Unconditionally cancellable commitments generally arise in the context of retail transactions, meaning an unnecessarily high CCF would also harm consumers in various ways. Many credit cards and HELOCs are “unconditionally cancellable” for purposes of the capital rules and are assigned a CCF of 0 percent under the Standardized Approach. The new 10 percent CCF would therefore increase capital requirements for unconditionally cancellable commitments and could lead to banks reducing credit limits on or canceling infrequently used lines. This raises significant concerns about the effects on households

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<sup>186</sup> See TCH Research Study, *supra* note 117.

<sup>187</sup> Using a panel data set of annual (Q4) bank-specific observations from the 2014 through 2022 Q4 FFIEC 101 reports, we regress the ratio of RWAs to current balance against the ratio of total committed line to current balance, with the inclusion of bank-fixed effects. Results indicate that the implicit risk weight for a 100 percent utilized credit line (represented by the estimated intercept term) is at least 20 times larger than that applied to undrawn line amounts (represented by the slope coefficient).

<sup>188</sup> See Financial Conduct Authority, *Credit Card Market Study Interim Report: Annex 11 – International Comparisons*, (Nov. 2015), available at <https://www.fca.org.uk/publication/market-studies/ms14-6-2-ccms-annex-11.pdf>.

that prefer to maintain unused lines of credit for contingency purposes. This is likely to include many financially vulnerable households that reserve unused line amounts for emergency expenses.<sup>189</sup>

2. The treatment of commitments that provide for automatic cancellation due to deterioration in a borrower’s creditworthiness should be revised.

As noted above, the proposal would apply a 10 percent CCF to commitments that are unconditionally cancellable, while commitments that are not unconditionally cancellable would generally have a 40 percent CCF. The current definition of “unconditionally cancellable” (which would apply to both the Expanded Risk-Based Approach and the Standardized Approach) is “with respect to a commitment, that a [bank] may, at any time, with or without cause, refuse to extend credit under the commitment (to the extent permitted under applicable law).”<sup>190</sup> The Basel framework incorporates a broader definition that includes commitments that effectively provide for automatic cancellation due to deterioration in the borrower’s creditworthiness.

The treatment in the Basel framework better reflects the actual economic risk of the exposure. These commitments pose only a small amount of credit risk since they automatically terminate when an automatic termination event (*e.g.*, payment default, bankruptcy or insolvency, or a downgrade below investment grade) occurs. Liquidity facilities that provide municipalities with a backstop for publicly issued variable rate debt and commercial paper are often designed in this way. These facilities meet a narrowly defined need, are rarely used in practice and, given their design, do not expose the banks that provide these facilities to appreciable credit risk. Most importantly, they automatically terminate upon the occurrence of an event implicating the borrower’s creditworthiness.

The agencies offer no explanation or rationale for this departure from the Basel framework and should provide a more risk-sensitive treatment for these exposures.

3. Proposed Section 112(a)(5) would result in excessive commitment amounts for charge cards and would apply to credit arrangements for which it was not designed or intended and should be revised.

The proposal would include a new approach, in proposed Section 112(a)(5), to determine the notional amount of an off-balance sheet commitment that does not have (i) an express contractual amount that can be drawn, or (ii) a pre-set limit. The approach requires the average amount drawn over the prior eight quarters to be multiplied by 10. The multiplier of 10 would result in excessive commitment amounts both for charge cards (for which the provision was designed) and other credit arrangements (for which it was not designed).

For charge cards, a multiplier of 10 would result in an excessive commitment amount. The proposal indicates that “supervisory experience suggests that obligors similar to those with charge cards have average credit utilization rates equal to approximately 10 percent.”<sup>191</sup> However, without the data behind this “supervisory experience,” we cannot meaningfully comment on the agencies’ method of calculating the multiplier. Assuming “obligors similar to those with charge cards” means credit card

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<sup>189</sup> For additional discussion of the harmful effects of the increased CCF and other elements of the proposal on retail borrowers, see Calem and Covas, *Retail Lending*, *supra* note 8, and attached as Appendix 2.

<sup>190</sup> 12 C.F.R. §§ 3.2; 217.2; 324.2.

<sup>191</sup> 88 Fed. Reg. at 64, 056.

holders, it is inappropriate to assume the same credit utilization rate for charge card holders, as the multiplier of 10 appears to be designed and calibrated on the basis of the 10 percent CCF for unconditionally cancellable commitments. Charge card products differ, but many are structured to have no pre-set credit limit (*i.e.*, they do not offer, communicate or imply a contractual commitment to extend a certain amount of credit to the customer) and are generally required to be paid in full each statement period. There may be other structural differences between charge cards and credit cards too, such as in connection with transaction approval processes. For example, a charge card could be structured so that the bank engages in transaction-by-transaction reviews in which each transaction is separately underwritten at the time of the transaction and approved or denied based upon a variety of non-limit-based factors, in contrast to processes for a credit card which could be structured to center on borrower standing (current versus delinquent) and amounts undrawn on the line. The agencies, however, offer no analysis or discussion as to whether, in light of the differences between credit cards and charge cards, there actually are risks relating to consumer use of charge cards that should be capitalized through a proxy commitment. Given the differences that do exist, a multiplier of 10 would result in an excessive commitment amount for charge cards, and the agencies should develop a treatment for charge cards based on the actual performance of those cards. For example, the agencies should examine changes in charge card balances relative to historical amounts for card holders who become delinquent and default.

In addition, banks may have other credit arrangements, including wholesale lending arrangements, for which there may not be an express contractual maximum amount that can be drawn. These credit arrangements could be subject to the method of calculating a proxy for the undrawn commitment amount in Section 112(a)(5). However, it would be inappropriate to determine a commitment amount for these arrangements through the use of a multiplier designed to determine a proxy commitment amount for a charge card or retail customer transactions in general. Therefore Section 112(a)(5) should exclude credit arrangements, like wholesale lending arrangements, that are outside the retail context, given the agencies' calibration of the requirement appears to be based on experience in the retail lending context.

A revised approach to determining the off-balance sheet commitment amount for a commitment that does not have an express contractual limit, based on the multiplier described above, should also be extended to determine the undrawn commitment amount for transactor exposures. As discussed in further detail below, a transactor exposure is a "regulatory retail exposure that is a credit facility where the balance has been repaid in full at each scheduled repayment date for the previous 12 months or an overdraft facility where there has been no drawdown over the previous 12 months."<sup>192</sup> Transactors therefore represent the highest credit quality customers of a bank. Consequently, they often have credit limits that are much higher than the amounts they actually borrow through the credit facility. However, as described above, under Section 112 of the proposal, a bank would have to determine the amount of an off-balance sheet unconditionally cancellable commitment to a transactor by multiplying the undrawn amount of the commitment by a 10 percent CCF. Such an approach would result in an overstatement of the credit exposure from the commitment given the high credit limits of transactors and the low utilization rates for these exposures. The agencies should therefore provide that the off-balance sheet amount of an unconditionally cancellable commitment exposure to a transactor is the lower of the approach using the CCF applicable to unconditionally cancellable commitments (including our recommendation described in Section IV.B.1) or the approach under Section 112(a)(5) (as modified in accordance with our recommendation above). This would make the Expanded Risk-Based Approach more risk-sensitive as it would more reasonably capture a transactor's actual use of the credit provided under the commitment.

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<sup>192</sup> § \_\_.101.

**C. The costs of the retail exposure framework significantly exceed its benefits.**

The proposal would define a regulatory retail exposure as a retail exposure that meets three criteria: (1) a product criterion, *i.e.*, the exposure is in the form of a revolving credit or line of credit or term loan or lease,<sup>193</sup> (2) an aggregate limit and (3) a granularity limit. A retail exposure would include an exposure to a natural person or persons and certain exposures to SMEs. A transactor exposure is a regulatory retail exposure that either is a credit facility where the balance has been repaid in full at each scheduled repayment date for the previous 12 months or an overdraft facility where there has been no drawdown over the previous 12 months. Under section 111(g), transactor exposures would be subject to a 55 percent risk weight, regulatory retail exposures that are not transactor exposures would be subject to an 85 percent risk weight and other retail exposures would be subject to a 110 percent risk weight.<sup>194</sup>

1. The aggregate limit in the definition of regulatory retail exposure with respect to natural persons or SMEs should be removed.

In order to qualify as a regulatory retail exposure, the sum of the exposure and all other retail exposures to the obligor and its affiliates would not be permitted to exceed \$1 million.<sup>195</sup> In order to comply with this limit, banks would be required to track and aggregate credit exposures to a single natural person or to a single SME and its affiliates across different products. As an initial matter, exposures to natural persons would not typically exceed the \$1 million threshold, making the aggregate limit unnecessary. More fundamentally, the aggregate amount of exposure to an obligor does not correlate to the credit risk posed by that obligor. Banks have processes in place for prudent underwriting, which consider the creditworthiness characteristics of the obligor, sources of repayment, pledged collateral and other information relating to credit risk. The aggregate exposure limit therefore does not improve risk-sensitivity and does not justify the substantial costs imposed by requiring banks to aggregate exposures across products to a particular obligor. The agencies should therefore exclude this part of the definition of regulatory retail exposure.

In addition, the aggregate limit for regulatory retail exposures would create a cliff effect for certain loans. For example, a loan for \$1 million could qualify as a regulatory retail exposure, receiving a risk weight of 85 percent and resulting in RWAs of \$850,000. The same loan for \$1,000,001 would not qualify as a regulatory retail exposure and thus would be subject to a risk weight of 100 percent as a corporate exposure. This would result in RWAs increasing by \$150,001 for only a \$1 increase in loan size. Although this issue is less consequential for natural persons, who rarely borrow over \$1 million, it has significant implications for SMEs, which are more likely to have borrowing needs in amounts approaching or exceeding \$1 million. The effect would be especially pronounced for larger SMEs that have grown to be able to support such borrowing amounts. To reduce the negative impact of this cliff effect on SMEs, the agencies should include a corporate SME exposure category with a risk weight of 85 percent in the final rule for all exposures to SMEs that do not qualify as retail exposures.

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<sup>193</sup> § \_\_.101.

<sup>194</sup> See Section IV.A.1 above for our recommendation regarding calibrating those risk weights.

<sup>195</sup> See § \_\_.101.

2. The granularity limit in the definition of regulatory retail exposure should be eliminated.

In addition to the product criterion and the aggregate limit included in the definition of regulatory retail exposure, the proposed rule would impose a granularity limit, whereby the portion of any regulatory retail exposure that exceeds 0.2 percent of the bank's total regulatory retail exposures would not be treated as a regulatory retail exposure. The proposed granularity limit would introduce undue complexity into the capital framework, as well as potential variability in capital requirements for the same exposure from one bank to another and also within the same bank from period to period. If the granularity limit were implemented, two banks with identical exposures to the same obligor could be required to apply different risk weights to their respective exposures based on the overall size of their retail lending portfolios, a factor that has no bearing on the credit risk associated with the particular exposure at issue. Therefore, the granularity limit should be eliminated.

The granularity limit is also unlikely to serve its intended purpose relating to the diversification of regulatory retail exposures.<sup>196</sup> The limit of 0.2 percent is equivalent to 1/500 of a bank's regulatory retail portfolio. If the bank's regulatory retail portfolio is at least \$500 million, the granularity limit would never apply, given that the proposal caps any individual exposure at \$1 million. The granularity limit adds complexity to the capital framework with almost no corresponding benefit and should therefore be eliminated.

3. The risk-weight multiplier for currency mismatches on residential real estate exposures and retail exposures overstates risk and should be eliminated.

Section 111 of the proposal would include a 1.5 multiplier for a residential mortgage exposure to a borrower that does not have a source of repayment in the currency of the loan equal to at least 90 percent of the annual payment from either income generated through ordinary business activities or from a contract with a financial institution that provides funds denominated in the currency of the loan. The 1.5 multiplier would also apply to any retail exposure in a foreign currency to a borrower that does not have a source of repayment in the foreign currency equal to at least 90 percent of the annual payment amount from either income generated through ordinary business activities or from a contract with a financial institution that provides funds denominated in the foreign currency.

The 1.5 multiplier is not risk-sensitive. Just because a borrower does not have a source of repayment in the currency of the loan does not mean he or she presents 1.5 times more credit risk to the bank. Relatedly, this uniform multiplier completely ignores differences in correlation among price movements in different pairs of currencies. In addition, this aspect of the proposal would impose substantial implementation burdens on banks, especially because the multiplier could apply to any residential mortgage exposure – not just residential mortgage exposures in a foreign currency. They would have to undertake exposure-by-exposure reviews to determine whether the multiplier applies. This aspect of the proposal also has the potential to impose higher capital requirements on banks when there is not an actual currency mismatch. Capital requirements apply on a consolidated basis. Accordingly, subsidiary-level exposures factor into the RWAs of the parent bank. A parent bank could have a subsidiary in a foreign country and that subsidiary could make loans in that country denominated in that country's currency – for example, a UK bank subsidiary making loans denominated in British Pounds. For the UK

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<sup>196</sup> See 88 Fed. Reg. at 64,052 (“The aggregate limit and granularity limit are intended to ensure that the regulatory retail portfolio consists of a set of small exposures to a diversified group of obligors, which would reduce credit risk to the banking organization.”).

bank subsidiary, there is no currency mismatch. At the parent bank level, however, because the loan is not denominated in U.S. dollars, it could be subject to the risk-weight multiplier. The proposal includes no data or analysis to support the multiplier, and it should therefore be eliminated.

4. The lookback period should be shortened from 12 to six months in the definition of transactor exposure.

As noted above, a transactor exposure would be a type of regulatory retail exposure that is either a credit facility where the balance has been repaid in full at each scheduled repayment date for the previous 12 months or an overdraft facility where there has been no drawdown over the previous 12 months. A six-month lookback period is sufficient to capture obligors who generally repay their balances in full and present a lower credit risk. Six months rather than 12 also lessens the penalty to the bank if a creditworthy obligor inadvertently does not make a timely payment or overdraws their account one month. In addition, shortening the lookback period would reduce the implementation challenges associated with a 12-month lookback period. Therefore the definition of transactor exposure should provide for a six-month lookback period.

5. The definition of transactor exposure should not exclude exposures for which the balance due is zero or for which no payment is due on a particular payment date that would otherwise apply.

The definition of transactor exposure is intended to capture obligors who routinely repay their balances in full so that exposures to these obligors may be assigned a lower risk weight in accordance with the amount of credit risk they pose. However, banks often run promotions regarding the retail products that may qualify as transactor exposures. During a promotional period, there may be no payments required. In addition, obligors may not use their credit arrangements and establish a balance each and every month. The definition of transactor exposure should be revised to take into account promotional offers and the possibility of a zero balance by providing that an obligor is deemed to have repaid the credit facility in full at a scheduled repayment date if the balance due is zero or there is no payment due on a particular payment date that would otherwise apply (unless the absence of a payment due is the result of a foreclosure granted by the bank).

6. Banks should have the option to opt out of the 55 percent /85 percent /110 percent risk-weight framework for transactor exposures/regulatory retail exposures that are not transactor exposures/other retail exposures and instead apply a 100 percent risk weight to all retail exposures.

In light of the potential implementation burdens associated with applying the “regulatory retail” and “transactor” definitions discussed above, if the agencies do not eliminate the aggregate limit and granularity limit, banks should have the option to “opt out” of the regulatory retail framework and instead apply a 100 percent risk weight to all retail exposures. For firms with smaller retail portfolios, the operational complexity of implementing the 55/85/110 framework could outweigh the benefits of the lower risk weights, with the result that credit becomes more expensive or less available from those banks. This increased cost or contraction of available options could unnecessarily harm consumers. The 100 percent risk weight is consistent with the risk weight retail exposures would receive under the generally applicable Standardized Approach and with the highest possible risk weight under the regulatory retail framework in the Basel framework. This risk weight would be sufficiently conservative to avoid opportunities for a bank to seek to optimize its RWAs by opting out of the retail exposure framework.

**D. The proposed definition of defaulted exposures could harm consumers and is not operationally practicable.**

1. Certain short-term credit relief and overdrafts should not result in an exposure being considered a defaulted exposure.

The proposal would introduce new and expanded definitions of a defaulted exposure. A defaulted retail exposure would include any distressed restructuring. A distressed restructuring would include postponement of principal, interest or fees and extension of the term of the loan, either of which must be made for credit-related reasons. A defaulted exposure receives a risk weight of 150 percent, compared with the 55 percent, 85 percent or 110 percent risk weight that would be applicable to the retail exposure otherwise. The expansive definition of distressed restructuring for purposes of the defaulted exposure definition would impose unwarranted heightened capital requirements on banks for offering borrowers relief when they experience temporary financial hardship. The proposal provides no data or analysis to support such punitive risk weights.

For example, in the case of auto loans to LMI borrowers and other borrowers who may be experiencing temporary financial hardship, banks may offer a one- or two-month extension to help customers stay current on their loans and avoid default and repossession. In connection with this relief, a bank would assess the customer's willingness and ability to repay before granting the extension. If it cannot establish a customer's willingness and ability to repay, an extension would not be offered. In these circumstances, if an extension is provided, it should not be treated as a "distressed restructuring" resulting in the imposition of a 150 percent risk weight.

The agencies elsewhere have recognized the important role that such short-term relief can play in helping a borrower weather a temporary financial strain. In particular, during the COVID-19 pandemic, banks were broadly encouraged to offer this type of relief to customers adversely impacted by the pandemic and the economic turmoil it created.<sup>197</sup> While not mandated by the CARES Act, banking supervisors felt that such loan modification programs were positive actions to help mitigate the impact of the COVID-19 pandemic.<sup>198</sup> Surprisingly, the proposal includes no loss experience from this period in determining the appropriate risk weight; in fact, recent analysis by the FDIC suggests that, "[i]n contrast with trends in previous recessions, consumer lending continued during the pandemic and consumer loan performance remained strong, helped by government programs that supported individual incomes and forbearance programs."<sup>199</sup> The FDIC found that the share of credit card loans, auto loans and other consumer loans at banks that were noncurrent decreased to below pre-pandemic levels by the fourth quarter of 2021.<sup>200</sup> It is unclear whether the agencies intended to depart from their view during the COVID-19 pandemic that loan modifications can (and did) help consumers endure short-term financial

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<sup>197</sup> See Board of Governors of the Federal Reserve System, et al., "Interagency Statement on Loan Modifications and Reporting for Financial Institutions: Working with Customers Affected by the Coronavirus," (March 22, 2020), available at <https://www.fdic.gov/news/press-releases/2020/pr20038a.pdf>.

<sup>198</sup> See *id.*

<sup>199</sup> The Federal Deposit Insurance Corporation, "Consumer Lending Through the Pandemic and the Recovery," FDIC Quarterly Vol. 16 No. 1 (2022), available at <https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2022-vol16-1/article1.pdf>.

<sup>200</sup> See *id.*

stress, given the lack of discussion in the proposal regarding the potential effects of the “defaulted exposure” definition on the availability of relief for consumers experiencing temporary financial distress.

To avoid possibly unintended harm to consumers experiencing financial hardship, particularly LMI borrowers, the definition of defaulted exposure should allow for short-term relief after a bank makes an assessment of the obligor’s ability and willingness to eventually repay the exposure.

In addition, the agencies should revise the definition of defaulted exposure to exclude overdrafts that banks may allow as part of client activity or for other operational reasons unrelated to financial distress and after an assessment of protections and the obligor’s ability and willingness to repay the exposure. While banks generally require that any overdraft be covered by the client, there are instances where a bank may allow overdrafts to age longer than 90 days for a variety of reasons, including failed trade disputes, tax reclaims, relationship exits and account closures. Such circumstances are unrelated to a client’s ability to repay the overdraft and overdrafts extended in those circumstances should not be considered defaulted exposures.

2. The definition of defaulted exposure is not operationally practicable.

The new and expanded definitions for certain types of defaulted exposures (non-retail and non-residential real estate) would require banks to conduct ongoing credit monitoring and determine defaulted exposure status based on the obligor’s performance on *any* of its credit obligations (not just credit obligations to the bank holding the exposure). Monitoring the status of credit obligations – including *de minimis* obligations – owed to entities other than the bank itself is not operationally practicable and should be removed from the definition of defaulted exposure.

In most cases, banks do not have the type of information that would be required by the proposed rule. For instance, the definition would require banks to consider, among other things, how other creditors account for credit obligations of the obligor. Banks would not have insight into whether, for example, other creditors have placed credit obligations of the borrower in nonaccrual status, sold a credit obligation or taken a charge-off or negative fair value adjustment with respect to a credit obligation of the obligor for credit-related reasons. Further, the definition would require banks to consider the status of *any* credit obligation of an obligor to *any* creditor. Banks would not ordinarily have insight into the status of each and every credit obligation of an obligor, without regard to size or materiality.

In addition, the definition of defaulted exposure conflicts with the definition of defaulted exposure under U.S. GAAP and therefore creates inconsistency across reporting requirements. Under GAAP, impairments or write-downs occur once a creditor determines an exposure is uncollectable; that is, once all commercially reasonable means of collection have been exhausted. If the definition in the proposed rule is left unchanged, the decisions of third-party creditors could require an exposure to be considered defaulted while GAAP reporting would reflect a bank’s own assessment of an obligor’s likeliness to repay. This could result in the same exposure reported simultaneously as both defaulted and not defaulted across regulatory requirements.

Therefore, the definition of defaulted exposure should be revised to eliminate the requirement that a bank monitor the obligor’s performance on “any” of its credit obligations and be limited to material obligations to the bank holding the exposure at issue. The definition should remain principles based, requiring a bank to monitor and determine whether an obligor is unlikely to pay its material credit obligations.

3. The definition of defaulted real estate exposure should exclude previously defaulted exposures that resume performing.

The definition of defaulted exposure includes a distressed restructuring.<sup>201</sup> For defaulted retail exposures, an exposure that underwent a distressed restructuring is no longer a defaulted exposure once the bank “has reasonable assurance of repayment and performance for all contractual principal and interest payments on the exposure as demonstrated by a sustained period of repayment performance.”<sup>202</sup> There is no analogous provision for defaulted real estate exposures.

The definition of defaulted real estate exposure should clarify that an exposure that has undergone a distressed restructuring but has resumed performing its payment obligations no longer qualifies as a defaulted real estate exposure. Like re-performing retail exposures, re-performing real estate exposures present less credit risk than truly defaulted exposures and should therefore receive a lower risk weight. Without this change, the proposal would impose a permanent additional cost for a distressed borrower, despite that borrower working hard to become and remain current on their loan.

**E. There is no basis for imposing a risk weight in excess of 100 percent for subordinated debt or a covered debt instrument.**

Section 111 would assign a 150 percent risk weight to subordinated debt and covered debt instruments.<sup>203</sup> The term “subordinated debt instrument” is defined as “a debt security that is a corporate exposure, a bank exposure or an exposure to a GSE, including a note, bond, debenture, similar instrument, or other debt instrument as determined by the [agency], that is subordinated by its terms, or separate intercreditor agreement, to any creditor of the obligor, or preferred stock that is not an equity exposure.”<sup>204</sup> The term “covered debt instrument” generally includes debt to satisfy loss-absorbency requirements, such as the Federal Reserve’s LTD and TLAC requirements.<sup>205</sup> This requirement has no data or analytical basis and should be eliminated.

Applying a 150 percent risk weight to all subordinated debt instruments, solely as a result of subordination and without taking into account other factors that affect credit risk (such as overall creditworthiness of the obligor or collateral) would result in capital requirements that are not risk-sensitive, not commensurate with risk and overly stringent. The same is true for applying a 150 percent risk weight to all debt, including senior debt, that is issued to satisfy loss-absorbency requirements. The agencies should therefore remove the separate risk weight category for subordinated debt and covered debt instruments.

Further, the proposed definition is overbroad, which could lead to anomalous results. The definition above explicitly scopes in preferred stock that is not an equity exposure even though such preferred stock may not have the characteristics of subordinated debt, *i.e.*, subordinated “to any creditor

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<sup>201</sup> § \_\_.101.

<sup>202</sup> *Id.*

<sup>203</sup> § \_\_.111(h).

<sup>204</sup> § \_\_.101.

<sup>205</sup> See 12 C.F.R. §§ 3.2; 217.2; 324.2. The proposal notes that “covered debt instrument” includes “TLAC debt instruments.” 88 Fed. Reg. at 64,042.

of the obligor.” A concrete example is preferred stock issued by certain funds registered under the 1940 Act, in particular those that primarily invest in tax-exempt municipal bonds. The proposal (as well as the current Standardized Approach, under which the effect is less pronounced given that a 100 percent risk weight is applicable) would result in a risk weight for preferred stock issued by these funds that is much higher than the risk weight applicable to investments in the common stock of these funds, which would be treated as equity exposures to investment funds, with risk weights determined under a look-through approach.

As noted above, the proposed definition of “subordinated debt instrument” would include “preferred stock that is not an equity exposure.”<sup>206</sup> Preferred stock issued by 1940 Act funds is generally mandatorily redeemable and therefore classified as a debt security under GAAP.<sup>207</sup> For 1940 Act funds that primarily invest in municipal bonds, preferred stock is often the most efficient to structure their balance sheets because they can pass along the tax benefits of the underlying portfolio to investors in the form of exempt-interest dividends.<sup>208</sup> Preferred stock is also intended to effectively serve as the most senior security in such a fund’s capital structure, and the preferred stock often includes provisions limiting the fund’s ability to issue debt senior to the preferred.<sup>209</sup> In addition, preferred stock is considered a senior security under the 1940 Act<sup>210</sup> and as such should not be classified as a subordinated debt instrument under the capital rules. The securities of a 1940 Act fund, both debt and equity, are subject to regulatory oversight and strict leverage limits, with indebtedness limited to a much larger extent than preferred equity.

Preferred stock issued by a 1940 Act fund that invests in municipal securities would receive a 150 percent risk weight. An equity exposure to the fund would be subject to the look-through approaches in Section 142, with the underlying exposures receiving a risk weight of between 20 percent and 50 percent (depending on the mix of types of municipal bonds). The risk weight for the underlying exposures would then be multiplied by the leverage of the fund. For example, assume a fund has a 40 percent risk weight for its underlying exposures and has a leverage ratio of 40 percent based purely on the preferred stock it has issued. An equity exposure to that fund would therefore receive a risk weight of 67 percent. A preferred stock exposure to the same fund, however, would receive a 150 percent risk weight, despite the fact that the preferred stock is senior to the equity exposure and therefore presents less credit risk.

If the agencies retain the 150 percent risk weight for subordinated debt exposures and covered debt instruments, they should make the following changes to the scope and application of the risk weight. First, the definition of “subordinated debt instrument” should be revised to remove the reference to “preferred stock that is not an equity exposure” and therefore limited to preferred stock that otherwise

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<sup>206</sup> *Id.*

<sup>207</sup> See ASC 320-10-20.

<sup>208</sup> See 26 U.S.C. § 852(b)(5).

<sup>209</sup> In general, senior leverage can only be issued to a limited extent and for limited purposes, (*e.g.*, temporary cash flow needs; debt issued to refinance preferred; Tender Option Bonds, etc.) or with the consent of the preferred holder.

<sup>210</sup> 715 U.S.C. § 80a – 18(g). Unless otherwise provided, “senior security” means any bond, debenture, note, or similar obligation or instrument constituting a security and evidencing indebtedness, and any stock of a class having priority over any other class as to distribution of assets or payment of dividends; and “senior security representing indebtedness” means any senior security other than stock.

satisfies the definition; *i.e.*, preferred stock that “is subordinated by its terms, or separate intercreditor agreement, to any creditor of the obligor.”<sup>211</sup> This would avoid application of the 150 percent risk weight to preferred stock exposures that are the most senior securities of an issuer and therefore are not relevant given the agencies’ rationale for this aspect of the proposal.<sup>212</sup> Second, the agencies should cap the risk weight for credit exposures to borrowers the equity exposures to which are subject to the look-through approaches. The agencies should provide that the risk weight for a credit exposure to an investment fund cannot be greater than the risk weight for an equity exposure to that fund determined under the look-through approaches and excluding the leverage generated by those credit exposures (*i.e.*, in the example mentioned above, the risk weight would be capped at 40 percent because the leverage generated by the preferred stock would not be taken into account for purposes of the cap). This change would improve the risk-sensitivity of the Expanded Risk-Based Approach by preventing senior exposures from receiving higher risk weights than junior exposures.

**F. A 20 percent risk weight to transactions between IHCs of foreign banks and their foreign bank affiliates should be adopted to prevent unjustified capital charges.**

The proposal does not provide a separate risk weight category for the credit exposure of an intermediate holding company (“IHC”) of a foreign bank to its foreign bank affiliates. Instead, such an exposure would be treated like any other exposure to a bank and receive a risk weight of 40 percent if the affiliate is a Grade A bank.<sup>213</sup> To avoid imposing undue credit risk capital charges on IHCs, the agencies should provide for a 20 percent risk weight for credit exposures to an IHC’s foreign bank affiliates that are Grade A banks.

Other aspects of the regulatory framework treat exposures of IHCs to their foreign affiliates differently. For example, for purposes of determining the category to which an IHC or foreign bank belongs, the cross-jurisdictional activity indicator excludes inter-affiliate claims to the extent secured by financial collateral.<sup>214</sup> The Federal Reserve explained that this approach was justified due to the increased cross-jurisdictional activity of foreign banks: “Foreign banks’ U.S. operations often intermediate transactions between U.S. clients and foreign markets, including by facilitating access for foreign clients to U.S. markets, and clearing and settling U.S. dollar-denominated transactions. In addition, they engage in transactions to manage enterprise-wide risks. In these roles, they engage in substantial and regular transactions with non-U.S. affiliates.”<sup>215</sup> In addition, in the Federal Reserve’s annual stress tests, U.S. IHCs are not required to include any affiliate as a counterparty for the purposes of the counterparty default scenario.<sup>216</sup>

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<sup>211</sup> § \_\_.101.

<sup>212</sup> 88 Fed. Reg. at 64,042 (“The scope of the definition of a subordinated debt instrument is meant to capture the types of entities that issue subordinated debt instruments and for which the level of subordination is a meaningful determinant of the credit risk of the instrument.”).

<sup>213</sup> See § \_\_.111(h).

<sup>214</sup> 84 Fed. Reg. 59230, 59,238 (Nov. 1, 2019).

<sup>215</sup> 84 Fed. Reg. 24,296, 24,305 (May 24, 2019).

<sup>216</sup> Board of Governors of the Federal Reserve, 2023 Stress Test Scenarios, *supra* note 70.

**G. The definition of multilateral development bank should be amended.**

The proposal would not revise the existing definition of multilateral development bank (“MDB”). Unlike the definition of MDB in the U.S. capital framework, the Basel framework includes the International Finance Facility for Immunization as eligible for the zero percent risk weight applicable to MDBs.<sup>217</sup> Adding this entity to the list of MDBs in the capital rules would improve risk-sensitivity and achieve greater alignment with international standards.

**H. Additional due diligence requirements with respect to the credit risk framework should not be adopted.**

Question 12 of the proposal asks whether due diligence requirements should be integrated into the text of the final rule and the advantages and disadvantages of specifying increases in risk weights that would be required to the extent that due diligence requirements are not met, similar to the proposed risk-weight treatment for securitization exposures.

Adding due diligence requirements to the capital rules is unnecessary and would introduce unwarranted complexity into the regulatory framework for banks. The Interagency Guidelines Establishing Standards for Safety and Soundness (“Interagency Guidelines”)<sup>218</sup> sufficiently outline expectations for banks’ responsibilities with regard to understanding the credit risk to which they are exposed and maintaining the required amounts of capital against that credit risk. In addition, the Basel framework’s due diligence requirement is prescriptive as to safe and sound banking practices but does not have any effect on the capital requirement for any particular exposure. The Interagency Guidelines already fulfill this role.

Further, due diligence requirements with respect to credit risk would have to apply in the context of many business lines and products. The Interagency Guidelines already provide general principles that can be applied to particular businesses and products. Implementing a credit risk due diligence requirement would either consist of general principles, which is unnecessary due to the Interagency Guidelines, or be so specific as to be impracticable.

**V. The calculation of operational risk RWAs is unsupported and produces unjustifiably high capital requirements.**

As discussed in Section III.C. above, fundamental changes to the operational risk elements of the proposed capital framework are necessary to address the proposal’s massive over-calibration of operational risk capital. Furthermore, in many instances, the design of the Expanded Risk-Based Approach would result in disproportionate outcomes, operational issues, or compliance burdens incommensurate with the level of risk-sensitivity achieved. In addition to solving the fundamental issue of over-calibration, any final rule should also address these more focused (but nevertheless significant) problems. We provide specific recommendations below.

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<sup>217</sup> Basel framework, 20.14, note 8.

<sup>218</sup> See 12 C.F.R. part 30, Appendix A; 12 C.F.R., Appendix D–1 to part 208; 12 C.F.R., Appendix A to part 364.

**A. The internal loss multiplier should not be floored at one.**

The proposal provides a floor of one for the ILM, which would allow the unfavorable historical experience of a bank to increase the operational risk charge but would not allow favorable historical experience to decrease it. This approach departs from the Basel framework and its implementation in other jurisdictions.

According to the proposal, “[h]igher historical operational losses are associated with higher future operational risk exposure.”<sup>219</sup> The agencies further state that “[s]upervisory experience also suggests that operational risk management deficiencies can be persistent, which can often result in operational losses.”<sup>220</sup> The agencies produce no data or analysis to support these assertions. Nor do they present any analysis supporting the decision to floor the ILM at one, rather than allowing it to fluctuate symmetrically. Unless and until the agencies can provide relevant data and analysis for public consideration, the agencies should consider setting the ILM to one. As we discuss in further detail below, however, simply setting the ILM equal to one would not address the broad-based over-calibration of the operational risk capital charge, and additional changes would be required. Another alternative would be to let the ILM float symmetrically and reduce the ILM formula multiplier to address the broad-based over-calibration as we discuss in more detail below.

In the UK, the Prudential Regulation Authority (“PRA”) gave three reasons for why the ILM, as a “mechanical link” to historical losses, was inappropriate: (1) the ILM is non-linear, with operational risk capital requirements increasing more slowly as historical losses increase; (2) many operational loss events are “low-probability high-impact events,” which, given their heterogeneity, “are generally not good predictors of other unlikely events and therefore future losses;” and (3) the ILM is based on data from the previous 10 years, but the “information value of operational risk losses generally diminishes over time as business models and lending activities change.”<sup>221</sup> We agree with the PRA’s critique of the ILM. Inclusion of the ILM, as proposed, would penalize banks for one-time operational loss events that have limited predictive power. Flooring the ILM at one would impose this penalty without any possibility of a corresponding benefit for favorable operational loss history.

The capital framework already includes strong incentives for a bank to manage its operational risk, and a floating ILM with a floor of one is not necessary to incentive banks’ risk management practices. An operational loss has a direct effect on a bank’s net income and, therefore, its retained earnings and regulatory capital. The direct relationship between operational losses and a bank’s profitability and regulatory capital provide powerful and sufficient incentives for banks to manage and mitigate operational risk.

If the agencies ultimately retain a floating ILM, they should at least remove the floor in order to improve the risk-sensitivity of this aspect of the U.S. capital framework. They should, at the same time, reduce the ILM formula’s multiplier from 15, as discussed below. This would appropriately calibrate the ILM in light of the improvements to the services component proposed below in Section V.B, which would result in a more appropriately designed and calibrated BIC. For any given amount of operational losses, a

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<sup>219</sup> 88 Fed. Reg. at 64,086.

<sup>220</sup> *Id.*

<sup>221</sup> Prudential Regulation Authority, *CP16/22 – Implementation of the Basel 3.1 Standards*, 8.24 (Nov. 30, 2022), <https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards>.

lower BIC would mechanically result in a higher ILM. Thus, to retain the ILM's current calibration, the multiplier must be reduced to reflect parallel improvements in the BIC.

**B. The services component of the business indicator significantly overstates risk.**

Under the proposal, the services component of the BIC would be calculated as the sum of (1) the greater of fee and commission income or fee and commission expense, each based on a three-year rolling average, and (2) the greater of other operating income or other operating expense, again based on a three-year rolling average.

The BIC would impose excessive and unjustifiable operational risk capital requirements on banks whose business mix consists of significant noninterest revenues. Unlike the calculation of the interest component and the financial component of the BIC, the services component does not offset revenues with expenses. There is also no upward limit on the size of the service component; in contrast, for the interest component, there is a cap set at 2.25 percent of interest earning assets. This approach to calculating the operational risk charge for fee-based businesses results in excessive capital requirements that are unjustifiable (in comparison to the other components of the BIC) and unsupportable (in comparison to the historical losses related to those businesses). This flaw of the proposal could be remedied through a variety of approaches, possibly in combination, as discussed in detail below.

The Basel Committee recognized the issue in both its 2014 and 2016 consultations on the operational risk computation in the Basel framework. In 2014, the Basel Committee noted: "A small number of banks that are highly specialised in fee businesses have been identified as facing a disproportionately high capital impact under the [business indicator]. The problem stems from the structure of the [business indicator], 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."<sup>222</sup> The 2016 consultation proposed to address this over-capitalization by introducing a cap in the calculation of the services component: "The Committee adjusted the structure of the [business indicator] to address . . . [o]vercapitalisation of banks with high fee revenues and expenses[;] banks with a high fee component in respect to the overall [business indicator] amount have a very high [business indicator] value which results in capital requirements that are too conservative relative to the operational risk faced by these banks."<sup>223</sup> However, the final Basel framework did not include this adjustment, and the commentary accompanying the publication of the Basel framework does not provide a reason for abandoning the 2016 modification or any further discussion regarding banks with high fee revenues and expenses.

The Basel Committee is not alone in identifying this problem with the existing operational risk approach. BPI analysis previously demonstrated that the operational risk capital requirement calculated using the Basel framework's approach for operational risk is significantly higher than operational risk losses in the Federal Reserve's supervisory stress tests for almost all large banks, and that the difference in capital

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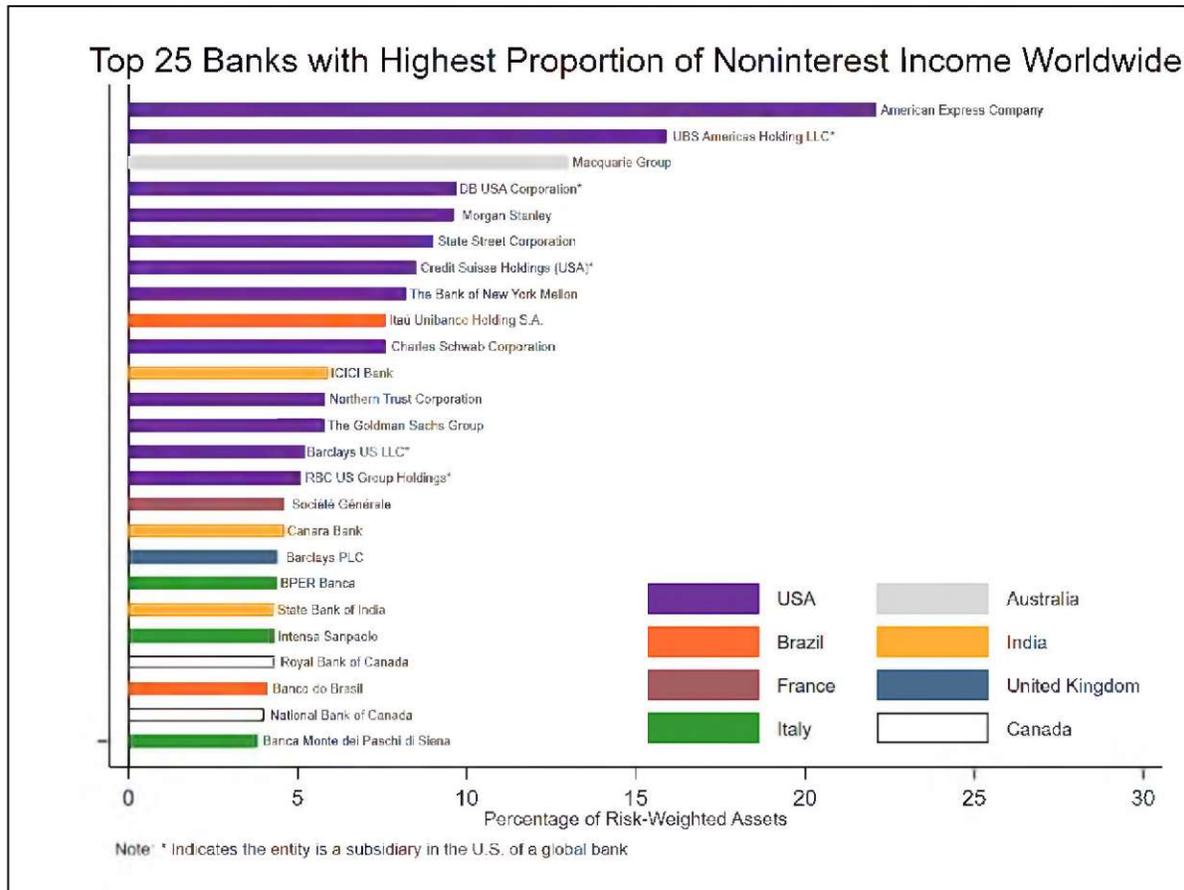
<sup>222</sup> Basel Committee on Banking Supervision, *Consultative Document: Operational risk – Revisions to the simpler approaches*, 3 – 4 (Oct. 2014), available at <https://www.bis.org/publ/bcbs291.pdf>.

<sup>223</sup> Basel Committee on Banking Supervision, *Consultative Document: Standardised Measurement Approach for operational risk*, 4 (Mar. 2016), available at <https://www.bis.org/bcbs/publ/d355.pdf>.

requirements is especially elevated for banks with proportionately higher fee revenue.<sup>224</sup>

This problem is particularly acute in the U.S. context. The U.S. banking system has a higher proportion of fee-oriented banks than other jurisdictions, especially when including Category III and IV banks and considering the recent trends in the evolution of U.S. banks’ fee income. As shown in the chart below, 12 of the 15 banks with the highest noninterest income relative to RWAs are subject to U.S. capital rules.

Figure 19



Failure to adjust the services component would disincentivize banks from diversifying their streams of revenue via custody, wealth management, investment advisory and other fee-generating activities. Governor Bowman explained that, “[d]iversification in revenue streams can enhance the stability and resilience of a bank, and excessive capital charges for these revenue-generating activities could create incentives for banks to roll back the progress they have made to diversify revenues.”<sup>225</sup> Furthermore,

<sup>224</sup> See Francisco Covas, Katie Collard, Brett Waxman, Gonzalo Fernandez Dionis and Jose Tapia, *A Modification to the Basel Committee’s Standardized Approach to Operational Risk*, Bank Policy Institute (May 4, 2022), available at <https://bpi.com/wp-content/uploads/2022/05/A-Modification-to-the-Basel-Committees-Standardized-Approach-to-Operational-Risk.pdf>, and attached as Appendix 17.

<sup>225</sup> Board of Governors of the Federal Reserve, “Statement by Governor Michelle W. Bowman,” (July 27, 2023), available at <https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm>.

wealth- and investment-management fee-based revenues have been shown to be durable in times of stress and to provide stable profit margins for banks. Discouraging banks from engaging in such activities therefore works against the safety and soundness of individual banks and the overall banking system by reducing diversification and increasing instability of revenues during times of stress.

A major contributor to the overstatement of services-related operational risk is the failure to net fee-based income with associated expense. The netting approach allows the incorporation of the costs of conducting such fee-based businesses and, as such, directly reduces the overstatement of the operational risk charge as currently proposed. The absence of a netting approach essentially links bank capital requirements to GAAP financial statement presentation requirements in a way that makes capital requirements arbitrary and susceptible to changes for reasons entirely unrelated to the purposes of the bank capital framework. For example, in 2014, the FASB adopted a new revenue recognition standard, which, among other things, revised how fee-related revenues are presented in financial statements. This standard was also amended multiple times prior to implementation. If these changes had been made after the implementation of the Expanded Risk-Based Approach, they would have affected banks' operational capital requirements. Any similar future changes in GAAP could significantly affect operational risk capital requirements for reasons entirely unrelated to the operational risk exposures of banks.

In addition, the proposal fails to recognize that different business lines vary significantly in their operational risk profiles. A properly calibrated rule should examine historical losses (on an industry-wide level) associated with each business line and differentiate the associated risk weight. An alternative would be to simply cap the amount of fee and commission income and expense included in the services component.<sup>226</sup>

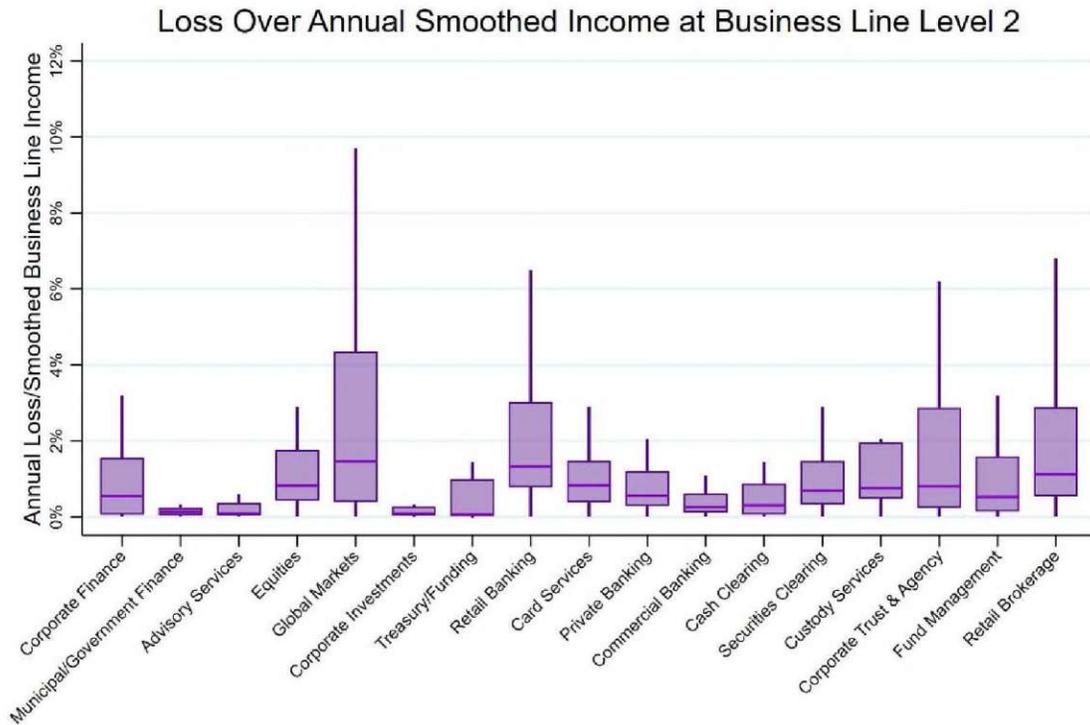
The recent ORX study mentioned above also investigated the relative riskiness across level two business lines listed in the Basel Committee's operational risk framework<sup>227</sup> and found significant variations in operational loss rates among them. The chart below illustrates the distribution of operational risk loss as a percentage of income, using bank-level data from the years 2003 to 2022. The median results show that custody services and fund management are less risky compared to global markets and retail banking. Within retail banking, card services appear to be relatively low risk. These findings are generally consistent when examining extreme losses and those at the 90th percentile. Therefore, the assumption that business lines do not markedly differ in risk profile is flawed.

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<sup>226</sup> Aside from flooring the ILM at one, the agencies' proposed operational risk framework is generally aligned with the Basel framework. In light of the substantial changes needed to arrive at an appropriate calibration of operational risk capital requirements for fee-based income, the agencies should also recommend that the Basel Committee revise its operational risk standard.

<sup>227</sup> See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, 146 – 48 (June 2006), available at <https://www.bis.org/publ/bcbs128.pdf>.

Figure 20



Source: ORX, <https://orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023>.

Given the importance of the new standardized approach for operational risk and its addition to the Expanded Risk-Based Approach, it is critical that the agencies address these issues in implementing the Basel framework in the United States. In the remainder of this section, we suggest a range of possible modifications to the services component of the proposed standardized approach for operational risk, which could be adopted in combination. These modifications fit into one or more of the following categories: (1) offsetting commission and fee income with expenses; (2) acknowledging that different types of fee income possess distinct risk profiles; and (3) capping the fee income component in a manner akin to the interest, lease and dividend component.

First, commission and fee income could be offset with commission and fee expense, which would be consistent with the interest, lease and dividend and financial components of the business indicator and would mitigate, to some degree, the excessive calibration of operational risk capital requirements for fee-based businesses. The formula for the services component under this approach would be:

$$SC = |Avg_{3y}(\text{fee income}) - Avg_{3y}(\text{fee expense})| + |Avg_{3y}(\text{oth oper inc}) - Avg_{3y}(\text{oth oper exp})|$$

However, the implementation of netting can be difficult if it needs to be done at a granular level, which would be necessary to achieve proportionate reductions across firms with different business models.

Alternatively, instead of using expenses as the netting mechanism, the agencies could apply a

publicly disclosed pre-tax margin percentage (averaged over 12 quarters).<sup>228</sup> Effectively, this would reduce total service revenues to be between 30 percent to 40 percent of gross revenues. There are meaningful expenses that firms incur to generate fee income, but in many cases they are not directly linked as expenses that can be readily identified in a netting formula. While pre-tax margin percentages are firm-wide calculations, and thus do not specifically relate to the services component, they could be viewed as a fair proxy for the general cost of doing business across multiple business lines. While not a prudential regulatory metric, pre-tax margin percentages, defined as the parameter  $\theta$ , are included in publicly disclosed financials, so thus could be viewed as a reliable metric.<sup>229</sup> Under this approach, the formula for the services component would be as follows, with  $\theta$  set either on a firm-by-firm or industry-wide basis:

$$SC = \theta \times [Avg_{3y}(fee\ income) + Avg_{3y}(oth\ oper\ inc)]$$

Second, fee income could be weighted differently depending on its business line and historical losses associated with the business line. The weighting approach would make the operational risk capital framework more risk-sensitive, as different sources of fee income carry different amounts of operational risk. Under this approach, the formula for the services component would be:

$$SC = \sum_{i=1}^N \pi_i \times \max\{Avg_{3y}(fee\ income_i), Avg_{3y}(fee\ expense_i)\} \\ + \max(Avg_{3y}(oth\ oper\ income), Avg_{3y}(oth\ oper\ expense))$$

In this formula, the index  $i$  defines the level two business lines listed in the Basel Committee's operational risk framework.<sup>230</sup> The weight  $\pi_i$  is specific to each business line and would be less than or equal to 100 percent. The table below contains the risk weights obtained by normalizing the highest loss ratio in the ORX analysis to 100 percent and setting the remaining risk weights proportionally.<sup>231</sup>

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<sup>228</sup> Pre-tax margin percentage is defined as income before taxes divided by the sum of net interest and noninterest income.

<sup>229</sup> Alternatively, applying a (1-efficiency ratio) to the services component could work in a similar way. Efficiency ratios can be easily calculated using publicly available data and are defined as noninterest expense divided by the sum of net interest income and noninterest income.

<sup>230</sup> See Basel Committee on Banking Supervision, *International Convergence of Capital Measurement and Capital Standards*, *supra* note 227.

<sup>231</sup> Results are similar if the 90<sup>th</sup> percentile of operational risk losses to revenues is used instead of the median.

Figure 21

Business Line	US Median Loss Ratio (%)	"Risk-Weight"
Corporate Finance	0.55	37%
Municipal/Government Finance	0.13	9%
Advisory Services	0.09	6%
Equities	0.82	56%
Global Markets	1.46	100%
Corporate Investments	0.09	6%
Treasury/Funding	0.06	4%
Retail Banking	1.33	91%
Card Services	0.83	57%
Private Banking	0.56	39%
Commercial Banking	0.26	18%
Cash Clearing	0.30	21%
Securities Clearing	0.69	47%
Custody Services	0.76	52%
Corporate Trust & Agency	0.80	55%
Fund Management	0.53	36%
Retail Brokerage	1.12	77%

Third, the agencies could include a cap on the amount of fees included in the services component calculation, either for all banks or for banks with a relatively large share of fee income. If the cap is applied to all banks, we propose a cap of 25 percent of the unadjusted business indicator to provide a somewhat comparable adjustment to some of the other adjustments discussed herein. The formula for the service component would therefore be:

$$SC = \min(0.25 \times unadj. BI, \max(Avg_{3y}(fee\ income), Avg_{3y}(fee\ expense))) + \max(Avg_{3y}(oth\ oper\ inc), Avg_{3y}(oth\ oper\ exp))$$

**C. Our quantitative impact study examines various possible options to improve the calibration of operational risk RWAs.**

BPI staff undertook a quantitative impact study to consider the hypothetical impact on the services component RWAs for operational risk of the various alternatives described above, as well as changes to the ILM as described in Section V.A.<sup>232</sup> The results presented below are based on data provided by 16 of

<sup>232</sup> Appendix 18 provides the template and instructions of the Operational Risk QIS.

the banks subject to the proposal. The sample includes universal banks, high fee income banks and banks with business models focused on lending. Collectively, these banks represent approximately 70 percent of total RWAs for operational risk under the proposal.<sup>233</sup> The QIS collected data on revenues and expenses by lines of business for each bank. The definition of lines of business followed the Basel framework, defined as in OPE 25.16.

The objective of the QIS was to understand possible solutions for both:

- The broad-based over-calibration of the operational risk capital charge; and
- The specific over-calibration related to banks with high fee income.

With respect to solutions for the broad-based over-calibration, the study examined two possibilities: setting the ILM to one (Figure 22) and allowing a symmetrically floating ILM while reducing the 15x loss multiplier (Figure 23). For each of these two options, several solutions to address the over-calibration of the services component were considered. To facilitate the comparison across all approaches, the services component and RWAs for operational risk under the baseline case (*i.e.*, calculation of operational risk as proposed without modification) are indexed at 100.

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<sup>233</sup> That is, relative to the \$1,950 billion increase in RWAs for operational risk.

Figure 22

QIS on the Services Component	Services Component <sup>(1)</sup>	Effect on Risk-Weighted Assets		
		Setting the Current ILM Equal to 1 <sup>(2)</sup>	Setting the Projected ILM as of the Implementation Date Contemplated by the Proposal Equal to 1 <sup>(3)</sup>	Setting the Projected ILM as of the Implementation Date Contemplated by the Proposal Equal to 1 and Accounting for 6% Revenue Growth <sup>(4)</sup>
<b>Baseline - aggregate results</b>		79	89	90
First quartile	100	69	87	88
Median		85	99	100
Third quartile		100	100	100
<b>Netting Fee Income and Expenses</b>				
Offset fee income with fee expenses - aggregate	74	69	78	79
Offset fee income with fee expenses - first quartile	73	60	66	66
Offset fee income with fee expenses - median	81	72	86	86
Offset fee income with fee expenses - third quartile	88	85	90	90
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - aggregate	27	50	56	57
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - first quartile	19	37	42	42
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - median	25	45	46	47
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - third quartile	29	59	65	65
<b>Risk-Weighting Business lines</b>				
ORX Service Component weights at the median - aggregate	62	64	72	73
ORX Service Component weights at the median - first quartile	55	56	59	60
ORX Service Component weights at the median - median	68	59	62	63
ORX Service Component weights at the median - third quartile	76	72	83	84
ORX Service Component weights at the 90th percentile - aggregate	60	62	71	72
ORX Service Component weights at the 90th percentile - first quartile	56	55	61	61
ORX Service Component weights at the 90th percentile - median	62	63	66	66
ORX Service Component weights at the 90th percentile - third quartile	75	71	81	82
Offset fee income with fee expenses & ORX Service Component weights (at the median) - aggregate	46	57	65	66
Offset fee income with fee expenses & ORX Service Component weights (at the median) - first quartile	41	50	54	55
Offset fee income with fee expenses & ORX Service Component weights (at the median) - median	51	56	59	60
Offset fee income with fee expenses & ORX Service Component weights (at the median) - third quartile	56	66	79	79
<b>Capping the Services Component</b>				
Services Component does not exceed 25% of BI - aggregate	51	60	67	68
Services Component does not exceed 25% of BI - first quartile	33	45	49	49
Services Component does not exceed 25% of BI - median	42	52	56	57
Services Component does not exceed 25% of BI - third quartile	58	67	75	75

(1) The services component as defined in the U.S. proposal is normalized to 100.

(2) Effect on operational risk RWA by setting ILM to 1 and RWA for operational risk with current ILM and the floor of 1 is set to 100.

(3) Effect on operational risk RWA by setting ILM to 1 and RWA for operational risk with projected ILM when the rule goes into effect and the floor of 1 is set to 100.

(4) Effect on operational risk RWA by setting ILM to 1 and RWA for operational risk with projected ILM when the rule goes into effect, 6% growth in the BIC and the floor of 1 is set to 100. We assume the growth in the BIC only affects the ILM and not the various adjustment to the services component for simplicity.

Figure 22 illustrates the changes in the services component and RWAs from each of the various options previously discussed to address the over-calibration of operational risk for high fee income banks and from setting the ILM to one. Due to variations in bank business models, the table shows the weighted average (aggregate), the median and the first and third quartiles of the distribution of changes in RWAs.

As shown in the first column, the capital charge associated with the services component could be reduced substantially across the three main solutions to address the over-capitalization for operational risk

of high fee income banks. Under the netting-type solutions, offsetting fee income with fee expenses would result in a 26 percent reduction in the services component in the aggregate. It is also important to note that the median bank sees a 19 percent reduction and the weighted average is near the first quartile, showing that this solution would benefit some banks much more than others. The pre-tax margin approach, which would provide a more consistent treatment of netting across business lines, would yield a 73 percent reduction in the services component in the aggregate. As shown in the table above, the aggregate change is about the same as the change for the median bank.

Additionally, assigning risk weights to different business lines using the ORX risk-weights would decrease the services component by 38 and 40 percent, depending on whether median or 90th percentile risk weights are used. Combining netting with a risk-sensitive approach (using median risk weights) for evaluating the services component's riskiness would reduce the services component by nearly 55 percent. Finally, imposing a cap on the services component at 25 percent of the business indicator would lead to a 49 percent reduction in the aggregate.

The next three columns on Figure 22 assess the overall effect of setting the ILM to one on RWAs for operational risk. The second column applies the current ILM, which still includes the large litigation losses banks incurred in 2013 and 2014, whereas the third column reflects each bank's best estimate of what the ILM would be as of July 1, 2025, the implementation date contemplated by the proposal, given the roll-off of those losses. The last column reflects the impact of six percent growth in bank revenues on the ILM.

The RWA reduction benefit from setting the ILM equal to one can be significant when ILMs are high, however, this benefit is likely to be significantly lower on July 1, 2025 than it would be based on current estimates, given that, all else being equal, ILMs would be lower because many of the large operational risk losses associated with the Global Financial Crisis would no longer be included in the 10-year lookback period by July 1, 2025. As such, allowing large litigation and operational losses to roll out of the lookback period provides a more accurate estimate of what the impact of setting the ILM to one would be on the proposed implementation date. For instance, under the baseline scenario, setting ILM equal to one would reduce RWA for operational risk by 21 percent relative to the current ILM, compared to an 11 percent reduction using the estimated ILM as of July 1, 2025. Moreover, the firm-specific impact from setting ILM to one is just one percent of RWAs for the median bank and varies significantly based on each firm's ILM. The first quartile corresponds to a 13 percent reduction, and a bank in the third quartile or higher would experience no benefit. The results in the last column show the effect of a six percent growth in revenues (assuming three percent growth each year), which reduces even further the effect of setting ILM to one.<sup>234</sup> Therefore, simply setting the ILM equal to one would not address the broad-based over-calibration of the operational risk capital charge.

Implementing an ILM of one as of July 1, 2025, combined with no revenue growth and adjustments to the services component, could reduce RWAs for operational risk in the aggregate by 22 percent when offsetting fee income with fee expenses, and as much as 44 percent with the pre-tax margin approach. The outcomes for other approaches for adjusting the services component fall within this specified range in the aggregate.

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<sup>234</sup> The last column in Figure 22 assumes no growth in operational risk losses. This is consistent with the ORX analysis, which shows a three percent increase in revenues and an eight percent decline in operational risk losses between 2012 and 2022. Due to rapid increase in the number of banks in the ORX sample 2003 and 2011, growth rates using data prior to 2012 are not dependable for estimating revenue growth.

As shown above, the RWA reduction from an ILM of one is less when considering the lower ILMs that would be calculated using data in 2025, when the large losses from the global financial crisis will have rolled off. And, of course, for banks that already have an ILM of less than one, setting the ILM equal to one would represent a penalty. Therefore, we also examine QIS results if the agencies allowed the ILM to float symmetrically, without imposing a minimum floor of one, and adjusting the 15x multiplier on the average annual net operational losses. The adjustment to the 15x multiplier is calibrated such that the overall capital impact, on average, across the banks in the sample is largely equivalent between setting the ILM at one or allowing it to float. Since a fixed ILM provides greater visibility and predictability into capital requirements and avoids discontinuous increases in the ILM following a significant operational risk loss, the calibration of the multiplier incorporates a five percent discount in RWA for operational risk versus the impact of calibrating the ILM equal to one.<sup>235</sup>

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<sup>235</sup> The five percent discount is meant to provide an example for the cost associated with the lack of predictability of capital requirements.

Figure 23

QIS on the Services Component	Effect on Risk-Weighted Assets		
	15x Average Losses (NPR)	Alternative ILM Calibration	
	ILM Floored at 1 <sup>(1)</sup>	Floating ILM <sup>(2)</sup>	Loss Multiplier where the Capital Impact is Largely Equivalent to setting ILM = 1 <sup>(3)</sup>
<b>Baseline - aggregate results</b>		84	
<b>First quartile</b>	100	82	9
<b>Median</b>		84	
<b>Third quartile</b>		86	
<b>Netting Fee Income and Expenses</b>			
Offset fee income with fee expenses - aggregate	90	74	8
Offset fee income with fee expenses - first quartile	88	69	
Offset fee income with fee expenses - median	93	74	
Offset fee income with fee expenses - third quartile	95	77	
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - aggregate	72	53	6
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - first quartile	49	38	
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - median	65	46	
Pre-Tax Margin x Avg 3-Yr Fee & Oth Op Income - third quartile	73	53	
<b>Risk-Weighting Business lines</b>			
ORX Service Component weights at the median - aggregate	86	68	7
ORX Service Component weights at the median - first quartile	72	58	
ORX Service Component weights at the median - median	87	67	
ORX Service Component weights at the median - third quartile	92	71	
ORX Service Component weights at the 90th percentile - aggregate	85	67	7
ORX Service Component weights at the 90th percentile - first quartile	72	57	
ORX Service Component weights at the 90th percentile - median	86	66	
ORX Service Component weights at the 90th percentile - third quartile	89	70	
Offset fee income with fee expenses & ORX Service Component weights (at the median) - aggregate	79	61	6
Offset fee income with fee expenses & ORX Service Component weights (at the median) - first quartile	65	49	
Offset fee income with fee expenses & ORX Service Component weights (at the median) - median	76	58	
Offset fee income with fee expenses & ORX Service Component weights (at the median) - third quartile	85	66	
<b>Capping the Services Component</b>			
Services Component does not exceed 25% of BI - aggregate	82	64	7
Services Component does not exceed 25% of BI - first quartile	56	43	
Services Component does not exceed 25% of BI - median	75	56	
Services Component does not exceed 25% of BI - third quartile	83	63	

(1) RWA for operational risk with ILM floored at 1 as of the implementation date contemplated by the proposal is set to 100.

(2) Each number represents a ratio where the numerator represents RWA for operational risk, calculated using a lower ILM multiple, without the floor of 1, and the BIC adjusted according to various changes to the services component. The lower ILM multiplier matches RWA for operational risk with ILM set to 1 with a 5 percent discount. The denominator is the RWA for operational risk as of the implementation date, using the 15x multiplier, the ILM floored at 1, and the BIC as per the baseline/proposal scenario.

(3) The multiple inside the ILM is the same across all banks.

The first column under 'ILM floored at 1' displays the results with a floating ILM and the 15x multiplier included in the proposal. At the aggregate level, the adjustments to the service component would reduce RWAs for operational risk by 10 percent when offsetting fee income with fee expenses, and as much as 28 percent with the pre-tax margin approach. The outcomes for other approaches for adjusting the services component fall within this specified range. As anticipated, the reductions in RWAs are much lower compared with setting the ILM at one. This effect is exacerbated by the fact that adjustments to the services component lead to a higher ILM, assuming all other factors remain constant.

Setting a loss multiplier that would make the capital impact, on average, largely equivalent between setting the ILM equal to one and a floating ILM would require the multiplier to be set to 9x under the baseline case. Additionally, the multiplier would fluctuate between 6x and 8x under the different methods used to adjust the services component. All other factors being equal, a lower calibration of the services component would decrease the BIC, which would, in turn, result in a higher ILM. Consequently, the more substantial the decrease in the services component, the greater the required reduction in the multiplier. As shown in the table, the various adjustments could reduce RWA for operational risk by 26 percent when offsetting fee income with fee expenses, and as much as 47 percent with the pre-tax margin approach. As before, the outcomes for other approaches for adjusting the services component fall within this specified range.

When evaluating the results of this QIS analysis, it is important to recognize that the impacts will vary significantly for individual banks, depending on their business model as well as the relative severity and timing of historical operational losses. Ultimately, any adjustment to the calibration of operational risk RWA must address both the general over-calibration of the operational risk capital charge and the specific over-calibration relating to banks with a high proportion of services fee income.

**D. The coefficients of the BIC should also be adjusted.**

The Basel framework's approach to calculating operational risk capital, and therefore the approach adopted by the agencies, has been acknowledged both by the Basel Committee itself and others to result in disproportionately high capital requirements for banks with a substantial proportion of fee-based business. A significant number of such banks are subject to the U.S. capital rules. The agencies should therefore implement one of the revised approaches described above to improve the risk-sensitivity of the approach, avoid penalizing banks for their fee-based business models and encourage diversification of revenue streams.

However, merely addressing issues with the services component will not address the more general over-calibration of operational risk capital requirements discussed in Sections III.C and V.A and B above. Given the current state of over-capitalization for operational risk – particularly in light of the additional capital requirements imposed by stress tests – we suggest a reduction in the coefficients of the BIC to further decrease the RWAs for operational risk and an adjustment to the business indicator ranges to account for economic growth and inflation relative to 2017. Alternatively, the Federal Reserve could also remove operational risk losses in the stress test (from peak to trough) from the BIC or reduce the size of operational risk losses in the stress tests. Either of these changes would help address the massive over-calibration of operational risk capital at the aggregate level, as discussed in Section III.C above; however, adjusting the BIC coefficients has the advantage of more appropriately reducing the over-calibration across individual banks.

**E. The definitions of “other operating income” and “other operating expenses” should exclude items that belong under interest income/expense and items that are not associated with financial services.**

Proposed Section 101 includes relatively brief definitions of “other operating income” and “other operating expense,” although additional guidance is provided in the footnotes to the preamble of the proposal. According to the preamble, other operating income includes “all other income items not currently itemized in the regulatory reports, which are not included in other business indicator items and are not specifically excluded from the business indicator.”<sup>236</sup> Other operating expense includes “expenses associated with financial services not included in other elements of the business indicator,” as well as expenses associated with operational loss events.<sup>237</sup> This approach misstates risk because it is over-inclusive in that it includes income and expense items that present operational risk more similar to that posed by interest income and expense and includes income and expense items that do not specifically relate to financial services.

Thus, the definition should be amended to (1) specify that income and expense associated with certain financial products be included in interest income and expense rather than other operating income and expense; (2) explicitly exclude certain items in regulatory reports that are not associated with financial services from other operating expense; and (3) modify the definition of “other operating income” to encompass only income associated with financial services, consistent with the definition of “other operating expense.”

First, the agencies should specify that the income and expense associated with certain financial products that are currently included in noninterest income/expense would be included in interest income/expense instead for purposes of calculating the interest, lease and dividend component of the operational risk charge. This would improve the risk-calibration of the operational risk framework because the operational risk from these items is more similar to that of other items of income/expense included in interest income/expense than that of items included in other operating income/expense. For example, interchange fees are the primary revenue stream for charge cards; therefore, these fees are more akin to interest on a loan and should be included in the interest, lease and dividend component. The same logic applies to all transactor cards; *i.e.*, the financial feasibility of the cards is driven by the core revenue from interchange fees. In addition, fee income and expenses from “operating leases,” fee income from “loan commitments” and noninterest income from the sale, securitization and servicing of 1 – 4 family residential mortgage loans should be included in interest income/expense rather than other operating income/expense.

Second, there are some expenses included in FR Y-9C, Schedule HI, Line 7d and Call Report, Schedule RI, Line 7d that are not explicitly excluded from the business indicator, but that are also not associated with “financial services.” Examples include marketing and business development expenses, audit fees and legal fees. These expenses should be expressly excluded from other operating expenses.

Third, the definition of “other operating expense” specifies that only expenses associated with financial services are included. This limitation is appropriate given that the services component is meant to capture the operational risk to a bank from the provision of financial services. The definition of “other operating income,” however, includes no such limitation. This gap inappropriately results in excessive

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<sup>236</sup> 88 Fed. Reg. at 64,084, note 186.

<sup>237</sup> *Id.* at 64,084.

operational risk capital requirements for the IHCs of foreign banks, which would have to include income received from affiliates in connection with corporate or shared services, such as those relating to information technology or human resources. To improve consistency within the rule and avoid undue operational risk capital charges for IHCs, the definition of “other operating income” should provide that it is limited to income items associated with financial services.

**F. In addition to the generally applicable threshold for operational loss events, there should be a separate, higher “materiality” threshold for an accounting restatement/correction to be treated as an operational loss event.**

As noted above, the ILM is based on a ratio of a bank’s historical operational losses to its BIC. Only material operational loss events, *i.e.*, those that resulted in a net loss of \$20,000 or more, are required to be included in the bank’s calculation of historical operational losses.<sup>238</sup> Section 101 would define “operational loss event” to include, among other things, restatements or corrections of financial statements that result in a reduction of capital relative to amounts previously reported. Because accounting restatements or corrections do not generally indicate increased operational risk, there should be a separate materiality threshold (in addition to that generally applicable to operational loss events) for an accounting restatement or correction to be treated as an operational loss event. This threshold should be set at the firm’s “error threshold” for making accounting adjustments. A firm’s auditors set this threshold based on the materiality of the change to the firm’s financial statements. Accounting restatements or corrections below this threshold likely do not rise to the level of increasing a firm’s operational risk.

In addition, certain types of restatements of financial statements should not qualify as operational loss events because they do not indicate any increase in operational risk. Specifically, the following types of changes to a bank’s financial statements should not constitute operational loss events even if the changes result in a reduction of capital relative to amounts previously reported:

- Retrospective application of a change in accounting principle;
- Retrospective reclassification due to a discontinued operation; and
- Restatements as a result of an acquisition or business combination of entities under common control.

These restatements do not result from any failure of a firm’s internal controls that could be an indicator that the firm is exposed to more serious operational risk, but rather are a result of subsequent events that merit a reframing of the firm’s financial statements. We note that, for purposes of its rule regarding recovery of incentive-based compensation in the event of erroneously reported financial information, the SEC has advised that a retrospective application for a change in accounting principle, a retrospective reclassification due to a discontinued operation and a retrospective application of a change in reporting entity, such as from a reorganization of entities under common control, “do not represent error corrections.”<sup>239</sup>

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<sup>238</sup> See § \_\_.150(e)(2).

<sup>239</sup> See Securities and Exchange Commission, 87 Fed. Reg. 73,076, 73,086 – 87 (Nov. 28, 2022).

These changes would improve the proposal’s risk-sensitivity by avoiding increases in a bank’s capital requirements in connection with accounting restatements or corrections that have no bearing on operational risk.

**G. The BIC thresholds of \$1 billion and \$30 billion and the materiality threshold for operational risk events of \$20,000 should be periodically updated for economic growth and inflation and other changes.**

The BIC would scale up with the business indicator based on thresholds of \$1 billion and \$30 billion. As described above, only operational risk loss events of \$20,000 or more would be required to be included in the ILM calculation. These thresholds would be static. This would result in operational risk capital charges increasing with economic growth and inflation. The thresholds should be indexed to economic growth and inflation, subject to automatic adjustment every five years, and periodically reviewed to determine whether other adjustments are appropriate. This would reduce the likelihood that the thresholds become improperly calibrated as a result of inflation or other changes in the banking sector.

**H. For purposes of collecting information regarding the drivers of operational loss events, the materiality threshold should be higher than \$20,000.**

The proposal would require banks to collect descriptive information regarding the drivers of operational risk loss events with a net impact of \$20,000 or more.<sup>240</sup> This requirement would pose a substantial operational burden on firms without a corresponding benefit. Operational loss events with an impact of \$20,000 are largely immaterial to banks with \$100 billion or more in assets. The threshold for collecting descriptive information regarding the drivers of operational risk loss events should be at least \$100,000.

**I. How banks should account for acquisitions or purchases of assets or portfolios in the BIC is unclear.**

An entity acquired or merged with a bank would need to be reflected in the business indicator and ILM components of the operational risk framework.<sup>241</sup> If a bank does not have complete operational loss event data or balance sheet or revenue data from a merged or acquired business, a formula would determine the business’s contribution to operational losses.<sup>242</sup> However, the proposal does not address how banks should account for non-legal entity acquisitions or purchases (e.g., a portfolio or asset purchase) or the purchase of legal entities where certain assets may be excluded (i.e., “carved out”) from the purchase.

Consistent with the implementation in certain other jurisdictions, such as Canada,<sup>243</sup> the Expanded Risk-Based Approach should provide that the acquired portfolio’s loss and other data arising pre-

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<sup>240</sup> § \_\_.150(f)(2)(i)(C).

<sup>241</sup> See § \_\_.150(d)(4) and (f)(2)(ii)(b).

<sup>242</sup> § \_\_.150(e)(2)(vi).

<sup>243</sup> See Office of the Superintendent of Financial Institutions, “Basel Capital Adequacy Reporting (BCAR) 2023,” (Oct. 2022), available at [https://www.osfi-bsif.gc.ca/Eng/fi-if/rtn-rlv/fr-rf/dti-id/Pages/BCAR21\\_BA.aspx](https://www.osfi-bsif.gc.ca/Eng/fi-if/rtn-rlv/fr-rf/dti-id/Pages/BCAR21_BA.aspx); see also Office of the Superintendent of Financial Institutions, “Update on Basel III Implementation ahead of final rules release in January 2022,” (Nov. 29, 2021) available at [https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/omni22\\_updt.aspx](https://www.osfi-bsif.gc.ca/Eng/fi-if/rg-ro/gdn-ort/gl-ld/Pages/omni22_updt.aspx).

acquisition are excluded because the acquisition is not of an entire legal entity and the bank is not integrating a company's business operations into its own; rather, it is executing an arrangement whereby a certain predefined set of assets will belong to the bank. Only post-acquisition loss and other data for purchased assets should be included in the calculation.

**J. Only significant acquisitions of non-banking entities should be included in the business indicator.**

Proposed Section 150(f)(2)(i)(B) would require banks to have operational loss event data collection processes that would produce operational loss event data relating to entities that have been acquired by or merged with a bank for 10 full years, including for any period prior to the acquisition or merger during the 10-year period. When a bank acquires a non-banking entity or a bank not subject to the Expanded Risk-Based Approach, collecting data for the calculation of the business indicator could present significant challenges. Non-banking entities are not subject to the agencies' regulatory reporting requirements and therefore may have incomplete data. The same is true for a smaller bank that is not subject to the Expanded Risk-Based Approach. The agencies should provide for a materiality threshold before data from acquired entities not subject to the Expanded Risk-Based Approach needs to be included in the business indicator.

In addition, there should be no requirement to capture pre-acquisition loss data from acquired companies regardless of materiality. Collection of such data presents the operational challenges discussed above and is not necessary given that the proposed rule provides a workable alternative for determining an acquired company's contribution to operational losses when such data is not available.<sup>244</sup>

**K. The revised FFIEC 101 report should provide for operational loss results to be reported on a two-month lag.**

The preamble states that the agencies are planning to separately propose modifications to the FFIEC 101 report so that all inputs to the business indicator and total net operational losses would be publicly reported as separate inputs to the applicable calculations.<sup>245</sup> Operational loss data should be reported on a two-month lag, given the various operational requirements for reporting.

This lag would enable banks to properly collect, review and validate the data regarding of operational losses. The verification and attestation processes many banks employ to validate their general ledgers could result in significant amounts of data not being properly validated prior to its reporting. Given the importance of the accuracy of this data, a two-month lag would be essential to complete and accurate reporting.

**L. The operational loss data requirements of any final rule should be forward-looking.**

The proposal requires certain operational loss data to be collected for prior periods. For example, the ILM is calculated based on operational loss data from the prior 10 years.<sup>246</sup> To account for circumstances in which firms previously collected data based on a different materiality threshold than

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<sup>244</sup> See *id.*

<sup>245</sup> 88 Fed. Reg. at 64,083.

<sup>246</sup> *Id.* at 64,086.

would apply under a final rule, the operational loss data requirements should only apply prospectively.

**VI. The calculation of equity RWAs under the Expanded Risk-Based Approach requires significant changes to improve risk-sensitivity and eliminate excessive and incorrectly calibrated capital requirements.**

- A. The proposal should (i) retain the existing treatment of non-significant equity exposures, (ii) expand the 100 percent risk weight category for equity exposures pursuant to a national legislated program and (iii) make a technical change to the treatment of exposures to small business investment companies.**

Under the current simple risk weight approach for equity exposures, the 100 percent risk weight category consists of (i) community development exposures, (ii) the effective portions of hedge pairs<sup>247</sup> and (iii) non-significant equity exposures, which are equity exposures (excluding significant investments in the capital of unconsolidated financial institutions in the form of common stock and equity exposures to leveraged investment firms not treated as a traditional securitization) the aggregate adjusted carrying value of which does not exceed 10 percent of the bank’s total capital.<sup>248</sup> The proposal would restrict the 100 percent risk weight category to (i) community development exposures and (ii) exposures to or held through small business investment companies.<sup>249</sup> As proposed, non-significant equity exposures would therefore be subject to a 250 percent risk weight if publicly traded and a 400 percent risk weight if not publicly traded.

The agencies have not presented any evidence that the current treatment of non-significant equity exposures results in those exposures being undercapitalized, nor have they presented an analysis of the effect of the elimination of the non-significant equity exposures treatment on investments that currently receive a 100 percent risk weight. These investments support important public policy and other similar objectives, and imposing higher capital requirements for those investments would undermine those goals. The agencies should therefore retain the existing treatment for non-significant equity exposures. For similar reasons, the 100 percent risk weight category for community development and small business investment company exposures should be revised to also include equity investments in projects that qualify for tax credits or that are part of programs established under the Internal Revenue Code, such as those for low-income housing, renewable energy investments or historic preservation/rehabilitation, whether or not they qualify as community development investments under Section 24 (Eleventh) of the National Bank Act.

- 1. Equity exposures pursuant to a national legislated program should receive a 100 percent risk weight.

The 100 percent risk weight category in the proposal should be revised to include equity exposures pursuant to all national legislated programs, including those that qualify for tax credits or qualify as participation in specific programs established under the Internal Revenue Code. Limiting the 100 percent risk weight category to exposures that qualify as community development investments under Section 24 (Eleventh) of the National Bank Act, as proposed, is insufficiently responsive to the full range of programs established by Congress in support of national public policy goals. Rather, any exposures pursuant to a

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<sup>247</sup> See Section VI.E below for our recommendation to retain hedge pair treatment.

<sup>248</sup> 12 C.F.R. §§ 3.52(b)(3); 217.52(b)(3); 324.52(b)(3).

<sup>249</sup> § \_\_.141(b)(3).

nationally legislated program, whether a community development investment qualifying under the National Bank Act or an investment eligible for tax credits or participation in specific programs under the Internal Revenue Code should qualify for a 100 percent risk weight. According to the Member QIS, applying the 100 percent risk weight to all equity investments made pursuant to national legislated programs as defined under the Basel framework would reduce the over-calibration of RWAs by 1.0 percent, on average.<sup>250</sup> This would help support bank investments, such as those for low-income housing, renewable energy or rehabilitation/historic preservation, that promote important social objectives that might otherwise be constrained in their ability to obtain long-term funding.

The proposal notes that community development investments would receive a 100 percent risk weight because they “generally receive favorable tax treatment and/or investment subsidies that make their risk and return characteristics different than equity investments in general” and are important “to promoting important public welfare goals.”<sup>251</sup> These considerations apply equally to other national legislated programs, such as those that support low-income housing, renewable energy, or rehabilitation/historic preservation, that likewise present less credit risk than other equity investments and should therefore receive a 100 percent risk weight.

The existence of national legislated programs like tax credits or other programs established under the Internal Revenue Code reflect Congress’s deliberate policy choice to encourage these investments by providing financial incentives to make them. The proposal would do the opposite by imposing much higher capital requirements that would, in most cases, make the investments uneconomic for banks. Furthermore, tax equity investments present less credit risk than other equity investments and more closely resemble loans. In a typical tax equity investment, the project sponsor will set up a limited liability company to conduct the activities eligible for tax credits. The tax credits the project is eligible for usually are greater than the sponsor’s tax liabilities, so the sponsor sells passive interests to tax equity investors. Those investors generally receive a pre-determined rate of return that is almost entirely based on the value of the tax benefits, leading to limited credit risk.<sup>252</sup> In recognition of the importance of tax equity financing and its similarities to lending, in 2021, the OCC streamlined the process for banks to participate in tax equity financing transactions that are the “functional equivalent of a loan.”<sup>253</sup> As the agencies recognize with respect to community development investments and investments in small business investment companies, tax equity investments also “generally receive favorable tax treatment and/or investment subsidies that make their risk and return characteristics different than equity investments in general”<sup>254</sup> and should therefore be treated consistently by providing a 100 percent risk weight for such exposures.

Equity exposures that support public policy goals, particularly those relating to supporting local communities and entrepreneurs, should also continue to receive a 100 percent risk weight along with

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<sup>250</sup> This corresponds to the decrease in RWAs resulting from applying a 100 percent risk weight for all national legislated programs, relative to the RWAs under the Expanded Risk-Based Approach. For a description of the study, including the study population and methodology, see Appendix 16.

<sup>251</sup> 88 Fed. Reg. at 64,077.

<sup>252</sup> See American Council on Renewable Energy, et al., *Letter to Dr. Lael Brainerd* (Aug. 22, 2023), available at <https://acore.org/wp-content/uploads/2023/08/ACORE-Letter-on-the-Impact-of-Proposed-Bank-Regulatory-Capital-Requirements-on-Tax-Equity-Investment-in-Clean-Energy.pdf>.

<sup>253</sup> See 12 C.F.R. § 7.1025.

<sup>254</sup> 88 Fed. Reg. at 64,077.

community development investments and small business investment companies under the proposal. This includes investments in community development financial institutions and minority depository institutions, which play a significant role in supporting local communities. Community development financial institutions receive the same treatment as community development investments and small business investment companies under the current capital rules as it relates to paragraph (7) of the definition of financial institution; yet under the proposal they are excluded from the types of equity exposures that would continue to receive a 100 percent risk weight.

2. The existing treatment of non-significant equity exposures should be retained.

Because the proposal does not include a separate risk weight for non-significant equity exposures, certain investment activities, including asset management-related seeding activities in funds that would not be capitalized under the market risk framework in the proposal, as well as investments in financial market infrastructure and venture capital investments, would be subject to the 400 percent risk weight. These investments promote diversification of banks’ revenue sources, support the maintenance and operation of financial market infrastructure, and promote other public policy objectives. The treatment of non-significant equity exposures should be retained to avoid disincentivizing banks from making these and other similar investments and in recognition of the fact that banks have developed business models and made investments based on the current treatment of non-significant equity exposures. According to the Member QIS, failing to retain the treatment for non-significant equity exposures will lead to an unnecessary 1.8 percent increase in RWAs, on average.<sup>255</sup>

Asset management activities include seed investments in funds that would not be subject to the trading book rules under the proposal.<sup>256</sup> These seed investments are used to support evolving client investment needs by establishing a performance track record. They are not entered into for trading purposes and are not designed to take balance sheet risk. These asset management activities provide a variety of benefits to banks, including by allowing banks to diversify their sources of revenue. In her statement regarding the proposal, Governor Bowman observed that “[d]iversification in revenue streams can enhance the stability and resilience of a bank.”<sup>257</sup> Furthermore, the impact of the proposal on bank asset management activities undermines the existing policy framework established by the Dodd-Frank Act and Volcker Rule, which reflect deliberate policy choices about the extent to which banks are permitted to make certain investments in funds. Senator Chris Dodd described the choices reflected in the Volcker Rule as being intended to “eliminate excessive risk-taking activities by banks and their affiliates *while at the same time preserving safe, sound investment activities that serve the public interest.*”<sup>258</sup> A potentially

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<sup>255</sup> This corresponds to the standalone impact, assuming, for example, that the implementation of a 100 percent risk weight for all national legislated programs does not occur. Also, the effect is relative to RWA under the Expanded Risk-Based Approach. For a description of the study, including the study population and methodology, see Appendix 16.

<sup>256</sup> The proposed rule’s definition of “market risk covered position” excludes “an exposure to a fund that has material exposure to” a specified list of non-covered position exposures. Accordingly, in these cases, applicable risk weights for seed investments in such funds would be determined under the credit risk framework rather than market risk framework.

<sup>257</sup> See Board of Governors of the Federal Reserve, Statement by Governor Michelle W. Bowman, *supra* note 225.

<sup>258</sup> 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (emphasis added).

fourfold increase in the risk weights applicable to these equity investments resulting from asset management activities, coupled with the impacts of the services component of operational risk discussed above in Section V.B, would, contrary to existing policy, strongly disincentivize the diversification of revenue streams away from lending and deposit taking to, for example, asset management activities.<sup>259</sup>

In raising this concern, we emphasize that the risk weight applicable to these seed investments is a distinct technical issue from the risk weight applicable to seed investments in funds that would be captured by the market risk framework under the proposal. While both types of seed capital investments have historically been eligible for inclusion in the 100 percent non-significant equity exposure bucket, under the proposal the elimination of the bucket uniquely impacts seed capital investments that remain in the credit risk framework. Specifically, 400 percent risk weight treatment would apply to non-market risk covered position seed capital investments in investment funds (*e.g.*, those holding non-publicly traded equity positions), as well as other funds having substantially all non-financial assets, such as real estate or infrastructure funds. Such a significant increase in risk weights would have meaningful impacts on banks' ability to provide seed capital to these funds, which are already subject to quantitative limitations by the Volcker Rule.

Investments that support the maintenance of critical financial market infrastructure would be subject to an increased risk weight as compared with their current inclusion in the non-significant equity exposure bucket. These investments include those in designated financial market utilities,<sup>260</sup> qualifying central counterparties,<sup>261</sup> and exchanges and trading venues. Strategic investments in financial infrastructure are minority, non-controlling interests in companies that are principally engaged in financial or related activities. They are generally long-term investments and are not intended for speculative purposes. Rather, they are made to support the functioning financial markets, which is consistent with regulatory objectives across jurisdictions and asset classes. In addition, membership in certain financial market utilities, such as the Depository Trust & Clearing Corporation, often requires banks to become shareholders of the entity, with the size of the stake generally determined by relative usage. These investments do not present heightened risks to banks, but rather are necessary to a bank's participation in the financial markets. The proposal's 400 percent risk weight for these investments is not appropriate in light of their characteristics and the importance of the investments to the stability of financial market infrastructure.

The elimination of the non-significant equity exposure bucket would also result in higher capital charges for (i) investments that play significant roles in supporting entrepreneurs, including qualifying

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<sup>259</sup> If, as we recommend in Section VI.D, the agencies provide banks the option to risk-weight seed investments that would be in the trading book under the proposal under either the trading book or banking book rules (provided the bank can demonstrate and document its lack of trading intent), those seed investments would also be subject to higher risk weights in the banking book as a result of the elimination of the non-significant equity exposures bucket. The same rationale for retaining the current non-significant equity exposure treatment would also apply to those seed investments. We support the recommendation in the letter submitted by ISDA and SIFMA that banks should have the option to treat these types of seed investments in funds under either the banking book or trading book rules, provided the bank can demonstrate and document its lack of trading intent.

<sup>260</sup> See 12 U.S.C. § 5461 *et seq.*

<sup>261</sup> 12 C.F.R. §§ 3.2; 217.2; 324.2.

venture capital funds<sup>262</sup> and others<sup>263</sup> and (ii) investments in financial technology providers. The application of the 400 percent risk weight to qualifying venture capital investments would be inconsistent with the policy rationale underlying the 2020 amendments to the Volcker Rule that provided an exclusion for these types of investments. In the preamble to the 2020 amendments, the agencies explained that they believed the exclusion for qualifying venture capital funds would “support capital formation, job creation, and economic growth, particularly with respect to small businesses and start-up companies.”<sup>264</sup> Preserving the non-significant equity exposures bucket is also justified by other federal programs supporting access to credit for small businesses and startups, such as the Equity/Venture Capital Programs of the State Small Business Credit Initiative,<sup>265</sup> which “provide capital in the form of equity investments to underserved startups and investors,”<sup>266</sup> including to venture capital funds in which banks have also invested, and the Capital Challenge program of the U.S. Economic Development Administration, which “seeks to increase access to capital where there is a limited supply of equity-based funding” and provides operational support for “the formation, launch, or scale of investment funds that seek to invest their capital in scalable startups.”<sup>267</sup>

Likewise, investments in emerging financial technology providers drive innovation and enhances competition, resulting in lower transaction costs, expedited workflows and greater liquidity for various asset classes. Such strategic investment initiatives have helped provide a framework for robust financial markets.

In addition, banks may not have to deduct defined benefit pension fund net assets held by a depository institution to the extent the depository institution holding company has unrestricted and unfettered access to the assets of the fund based on existing section 22(a)(5). Currently, such assets may be subject to the 100 percent risk weight given that they would be part of the non-significant equity portfolio. Under the Expanded Risk-Based Approach, the risk weight would likely go up to 250 percent given that the equities are generally publicly traded. Given the prudent investment style associated with pension fund assets in general, this increase is unwarranted and provides yet more support for the retention of the 100 percent risk weight non-significant equity investment bucket.

3. An exposure to a small business investment company should continue to be treated as such if the small business investment company has voluntarily surrendered its license.

The proposed treatment of small business investment company exposures should be revised so that an exposure to a small business investment company continues to be treated as such if a small

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<sup>262</sup> 17 C.F.R. § 275.203(l) – 1.

<sup>263</sup> See 12 C.F.R. § 248.10(c)(11)(iii) (rural business investment companies) and (iv) (qualified opportunity funds).

<sup>264</sup> 85 Fed. Reg. 46,422, 46,444 (July 31, 2020).

<sup>265</sup> U.S. Department of the Treasury, “State Small Business Credit Initiative,” *available at* <https://home.treasury.gov/policy-issues/small-business-programs/state-small-business-credit-initiative-sbcj>, was reauthorized and expanded under the American Rescue Plan Act of 2021.

<sup>266</sup> U.S. Department of the Treasury, “State Small Business Credit Initiative: Fact Sheet,” (June 2023), *available at* <https://home.treasury.gov/system/files/256/State-Small-Business-Credit-Initiative-SSBCI-Fact-Sheet.pdf>.

<sup>267</sup> U.S. Economic Development Administration, “Capital Challenge,” *available at* <https://www.eda.gov/funding/programs/build-to-scale/capital-challenge>.

business investment company has voluntarily surrendered its license under the Small Business Investment Act in connection with its decision to wind down.

Under the proposal, only equity exposures to an unconsolidated small business investment company or held through a consolidated small business investment company described in Section 302 of the Small Business Investment Act would receive a 100 percent risk weight. If a small business investment company decided to wind down and, in connection with that decision, voluntarily surrendered its license, the entity would no longer be a small business investment company as described in Section 302 of the Small Business Investment Act. As a consequence, the 100 percent risk weight would cease to apply. There is no supervisory or policy reason for a heightened risk weight to apply in these circumstances.

**B. The agencies should revise the proposed look-through approaches for equity exposures to investment funds to improve risk-sensitivity.**

The proposal would implement modified versions of the full look-through approach and alternative modified look-through approach, and also eliminate the simple modified look-through approach.<sup>268</sup> If a bank could not apply either the full or alternative modified look-through approach, a 1,250 percent risk weight would apply to the exposure.<sup>269</sup> The look-through approaches would take into account the on-balance sheet, off-balance sheet, and derivatives-related exposures of the fund, as well as any leverage.<sup>270</sup> The proposal would also have new, prescriptive requirements for the treatment of exposures to “funds of funds” and investment funds with underlying securitization exposures.<sup>271</sup>

- 1. The agencies should revise the proposed rule to provide that use of the full look-through approach is permissive rather than mandatory with respect to a fund for which a bank has adequate information.

Under Section 142(a)(1) of the proposal, if a bank has information from an investment fund that is verified on at least a quarterly basis by an independent third party and that is sufficient to calculate the RWA amount for each underlying exposure as if each exposure were held directly by the bank, the bank *must* use the full look-through approach, rather than the alternative modified look-through approach. Under the current rules, banks with sufficient information to calculate the RWA amounts of underlying exposures may use the full look-through approach, the simple modified look-through approach, or the alternative modified look-through approach. Banks should be able to choose to use either the full look-through approach or the alternative modified look-through approach, including with respect to Bank Owned Life Insurance/Corporate Owned Life Insurance (“BOLI/COLI”) separate accounts.<sup>272</sup> Use of the full-look through approach should be permissive, rather than mandatory, just as it is under the generally applicable Standardized Approach.

The full look-through approach requires banks to gather information and calculate risk weights for individual securities that are not directly owned by the bank. In some cases, application of the full look-

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<sup>268</sup> See § \_\_.142.

<sup>269</sup> § \_\_.142(a)(3).

<sup>270</sup> See § \_\_.142.

<sup>271</sup> See § \_\_.142(d) and (e).

<sup>272</sup> According to proposed Section 140(a)(2), these investments must be treated as equity exposures in investment funds under Section 142.

through approach would not be an efficient use of a bank's resources. For example, some investment funds have thousands of individual positions, but they may all be similar positions. Further, the utility of the full look-through approach, other than to calculate capital requirements, is limited. The full look-through approach output is produced on a lag and is therefore of little value to portfolio or risk management. With respect to BOLI/COLI specifically, policyholders are prohibited from using data provided to direct specific investments in the funds.

Making use of the full look-through approach optional would give banks a choice between the more conservative but less burdensome alternative modified look-through approach or the more risk-sensitive but also more burdensome full look-through approach. The alternative modified look-through approach is sufficiently conservative in design and calibration that this option would not permit a bank to reduce its RWAs by opting to apply the alternative modified look-through approach if it has the data to apply the full look-through approach.

In addition, in response to Question 70 in the proposal, banks should be able to use the full look-through approach when they receive from a third party the information necessary to calculate the risk weight associated with the equity exposure to the fund, consistent with the Basel framework and its proposed implementation in the UK.<sup>273</sup> Also consistent with the UK implementation, the risk weight resulting from third-party information should not be subjected to a scalar as the use of third-party information has no bearing on the risk associated with the equity exposure.

2. The requirement that a fund's financial information be verified by a third party on a quarterly basis to use the full look-through approach for exposures to that fund is unnecessary and should not be adopted.

Under the proposal, in order to use the full look-through approach with respect to a given fund, the fund's financial information must be verified on at least a quarterly basis by an independent third party, such as a custodian bank or management fund. This requirement would limit the number of investment funds eligible for the full look-through approach. This requirement is unnecessary to achieve any objective relating to the accuracy of the data used in the full look-through approach because banks conduct their own confirmations of the data provided by the funds in which they invest. The agencies should therefore remove this requirement to allow more funds to qualify for the full look-through approach, thereby improving risk-sensitivity. Alternatively, the agencies could revise the eligibility criteria for the full look-through approach to provide that a third party must audit the fund's financial statements or verify its holdings at least annually, which would similarly expand the number of funds eligible for the full look-through approach. This revised requirement would limit the availability to the full look-through approach to investment funds subject to a third-party review at least once a year, while avoiding the potential constraints on application of the full look-through approach if the requirement were that quarterly data be verified.

3. The upward adjustment based on CVA risk for derivative exposures held by an investment fund has no basis and should not be adopted.

Under the proposal's full look-through approach, the formula to calculate the exposure amount for derivative exposures held by an investment fund would include an upward adjustment if at least one of the

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<sup>273</sup> Basel framework, CRE 60.5; Prudential Regulation Authority, *CP16/22 – Implementation of the Basel 3.1 standards: Market risk* 6.51 (Nov. 30, 2022), available at <https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards/market-risk>.

derivative contracts in the netting set is a CVA risk covered position or if the bank cannot determine whether one or more of the derivative contracts within the netting set is a CVA risk covered position. The agencies provide no analysis for the calibration of the proposed 1.5x adjustment and do not address whether a 50 percent increase in the exposure amount for a netting set, including if a bank simply cannot determine whether one or more derivative contracts in the netting set is a CVA risk covered position, reflects the actual CVA risk to investment funds, taking into account the clearing<sup>274</sup> and margin requirements<sup>275</sup> that would often apply to derivative transactions with investment funds. The proposed 1.5x adjustment has no basis and should not be adopted.

4. The alternative modified look-through approach should allow banks to calculate the RWA amount of (i) derivatives and (ii) securitizations based on the actual volume of these exposures held by the investment fund.

The proposal requires banks calculating the RWA amount for their equity exposures in investment funds using the alternative modified look-through approach to calculate the RWA amount of derivative exposures under the assumption that the fund has invested in the maximum volume of derivative contracts permitted under its investment limits. Likewise, in calculating the RWA amount of on-balance sheet exposures under the alternative modified look-through approach, banks are required to assume that the fund has invested in the maximum amount of each exposure type, including securitizations, permitted under the fund's investment limits. The agencies should allow banks to base these calculations on the actual volume of derivative contracts and securitizations in which the fund has invested.

The assumptions in the alternative modified look-through approach regarding the volume of derivatives and securitizations held by an investment fund are overly conservative. Funds often include provisions that, read literally and in the most expansive language, could allow for investments in derivatives and securitizations, but neither of these types of investment is generally a substantial proportion of a fund's assets. Using the actual volume of derivatives and securitizations would therefore be more accurate and risk-sensitive.

5. The agencies should include thresholds before banks are required to use the look-through approaches to calculate securitization exposures, derivatives exposures and "fund of funds" exposures.

Both the full look-through approach and the alternative modified look-through approach require banks to take into account the investment fund's securitization and derivatives exposures. The proposal would also require banks to use the hierarchy of look-through approaches, based on the information available to the bank, to calculate investment funds' equity exposures to other investment funds. The agencies should provide that securitization exposures and derivatives exposures need only be calculated (under either approach) if the amount of exposures of the relevant exposure category exceeds 10 percent of the investment fund's assets. The agencies should likewise limit the requirement to use the look-through approaches for "fund of fund" exposures by, for example, limiting the look-through to one level, applying a percentage of assets materiality threshold or limiting the look-through only to those funds that

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<sup>274</sup> See generally 7 U.S.C. § 2(h); 17 C.F.R. Part 50.

<sup>275</sup> See generally 7 U.S.C. § 6s(e); 12 C.F.R. Part 45; 12 C.F.R. Part 237; 12 C.F.R. Part 349; 17 C.F.R. Part 23, Subpart E; 17 C.F.R. § 240.18a-3.

have an explicit mandate to invest in other funds. These changes would reduce the operational burden on banks while still capturing risk from significant exposures.

The proposal’s calculation of securitization and derivative exposures would present significant operational challenges as the amount of new data banks would have to collect would increase substantially. Further, as noted above, securitization exposures and derivative exposures rarely make up a significant proportion of funds’ assets. The treatment of “fund of funds” exposures would likewise be operationally burdensome for banks that might have to look through several layers of funds’ investments in other funds.

Limiting the application of the look-through approaches to securitization exposures, derivatives exposures, and “fund of funds” exposures would reduce the operational burden on banks while still capturing the risk from the most significant of these exposures.

6. The agencies should recalibrate the proxies for replacement cost and potential future exposure for derivative contracts held by investment funds when there is insufficient information to calculate these values.

Under either the alternative modified look-through approach or the full look-through approach, if there is not enough information to determine the replacement cost or potential future exposure (“PFE”) of a derivative contract, the proposal would require banks to use the notional amount as a proxy for the replacement cost and 15 percent of the notional amount as a proxy for the PFE.

The proxies proposed by the agencies could result in excessively high measures of exposure amounts, particularly for interest rate, foreign exchange and investment grade credit derivatives. Figure 24 below shows the standalone PFE add-on amounts under the SA-CCR for unmargined derivative transactions and derivative transactions with a margin period of risk (“MPOR”) of 10 business days:

**Figure 24**

	30Y IR	FX	7 Year IG SN	7 Year Speculative SN	7 Year Sub Speculative SN	Equity SN	Energy	Other Commodity
Margined	2.3%	1.2%	0.8%	2.3%	10.6%	9.6%	12.0%	5.4%
Unmargined	7.8%	4.0%	2.7%	7.7%	35.4%	32.0%	40.0%	18.0%

As Figure 24 shows, only unmargined equity, commodity and sub speculative credit derivatives would result in higher standalone add-ons than proposed. In light of that fact and the substantial variation in PFE add-on amounts, the agencies should use the following as the PFE add-on amounts:

- 2 percent, to the extent the bank determines the fund has margined interest rate, currency or credit derivatives.
- 10 percent, to the extent the bank determines the fund has margined equity or commodity derivatives.
- 7 percent, to the extent the bank determines the fund has unmargined interest rate, currency or credit derivative.
- 15 percent, to the extent the bank cannot determine the asset class of the fund’s derivatives or whether the fund’s derivatives are margined.

In relation to the replacement cost, if the bank knows that the derivatives of the fund are daily margined, the replacement cost should be zero. Otherwise, the replacement cost should be recalibrated. In this context it is helpful to review the derivative statistics provided by the Basel Committee. Figure 25 below shows the average ratio of gross market value and notional between the second half of 2021 and first half of 2023:

**Figure 25**

Asset Class	2021-S2	2022-S1	2022-S2	2023-S1	Average
FX	2.4%	4.3%	4.5%	3.6%	3.7%
IR	1.8%	2.3%	3.0%	2.5%	2.4%
Equity	9.0%	8.5%	7.3%	7.3%	8.0%
Comm	17.6%	31.1%	22.3%	13.4%	21.1%
Credit	2.3%	2.6%	1.9%	2.0%	2.2%

For foreign exchange, interest rate and credit derivatives, the replacement cost should be set at five percent of the notional amount, while for equity derivatives it should be 10 percent, and for commodity derivatives it should be 30 percent. If the bank does not know the composition of the fund’s holdings, the replacement cost should be set at 30 percent.

7. Banks should be able to use the collateral haircut approach to determine exposure RWAs for equity exposures to funds, including money market mutual funds, with repo-style transactions.

Many funds, in particular money market mutual funds, have repo-style transactions. If a bank applies the full look-through approach, the bank should be permitted to apply the collateral haircut approach to determine the exposure amount of the investment fund’s repo-style transaction. This would be consistent with the general principle underlying the full look-through approach – that the bank calculates the exposure and RWA amounts as though the bank held the investment fund’s exposures directly.

8. The denominator of the risk weight formulae in the look-through approaches should be “total exposure” rather than “total assets.”

Under section 142, the formulae in the full look-through and modified look-through approaches calculate the RWAs for an equity exposure to an investment fund using a denominator of “total assets,” which are “the balance sheet total assets of the investment fund.” However, the numerator of the formulae takes into account the fund’s off-balance sheet exposures. To account for off-balance sheet exposures in the denominator as well, the formulae should use the fund’s “total exposure” as the denominator.

**C. The agencies should revise the definition of “investment fund” and eliminate the separate risk weight for equity exposures to leveraged investment firms because the proposed look-through approach captures the leverage of an investment fund.**

1. The “no material liabilities” aspect of the definition of “investment fund” should be removed.

An “investment fund” is defined and would continue to be defined as a company (1) where all or substantially all its assets are financial assets and (2) that has no material liabilities.<sup>276</sup> This definition may have been appropriate when it was introduced in 2007; however, given that the capital framework has been updated to take into account the leverage of investment funds, the second clause of the definition is no longer necessary. An investment fund should be defined as a company (as defined in Section 2 of the current capital rules) that is not an operating company (also as defined in Section 2 of the current capital rules) and all or substantially all of the assets of which are financial assets.

When the agencies adopted the current definition of “investment fund” in connection with the implementation of Basel II, they noted that “[i]nvestment vehicles with material liabilities provide a leveraged exposure to the underlying financial assets and have a risk profile that may not be appropriately captured by a look-through approach.”<sup>277</sup> The agencies provided this explanation in the context of discussing comments on the proposed definition that “objected to the exclusion of investment funds with material liabilities from [the look-through] treatment, observing that it would exclude equity exposures to hedge funds,” as well as others that “suggested that investment funds with material liabilities should be eligible for the look-through approaches.”<sup>278</sup>

Though the look-through approach introduced in 2007 did not capture all the risk of leveraged investment funds, the proposal and the current full look-through approach do.<sup>279</sup> Under the proposal, banks would be required to multiply the average risk weight for equity exposure to an investment fund by the ratio of the total assets of the investment fund to the total equity of the investment fund. This adjustment is designed to capture the risk from an investment fund’s leverage by proportionately increasing the average risk weight of a bank’s equity exposure to the investment fund.

However, the proposal does not discuss to what extent a company could have leverage (and therefore liabilities) while remaining an investment fund – that is, the proposal does not address the extent to which leverage would not constitute “material liabilities” for purposes of the definition of investment fund. The agencies have not otherwise provided formal commentary, such as interagency FAQs or preamble discussions in rulemakings, on the definition of “investment fund.” Clause (2) of the definition of investment fund is not just unnecessary, it also introduces ambiguity into the capital framework and detracts from the overall coherence of the framework.

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<sup>276</sup> 12 C.F.R. §§ 3.2; 217.2; 324.2.

<sup>277</sup> Risk-Based Capital Standards: Advanced Capital Adequacy Framework – Basel II; Final Rule, 72 Fed. Reg. 69288, 69381 (Dec. 7, 2007).

<sup>278</sup> *Id.*

<sup>279</sup> See 88 Fed. Reg. at 64,079 – 80; note 166. The full look-through approach introduced in 2007 is the same as the current full look-through approach under the generally applicable Standardized Approach, which the agencies indicate implicitly captures an investment firm’s leverage.

In light of the fact that the current full look-through approach and the proposed look-through approaches are designed to capture a fund's leverage, as well as the fact that it is unclear to what extent a company could have leverage and still remain an investment fund, the agencies should revise the definition of investment fund so that a fund with material liabilities may be considered an investment fund.<sup>280</sup> The revision would make the capital rules clearer, more coherent, more risk-sensitive and simpler.

2. The separate risk weighting for equity exposures to leveraged investment firms serves no purpose and should not be adopted.

The proposal would assign a 1,250 percent risk weight to an equity exposure to a leveraged investment firm that is excluded from the definition of traditional securitization pursuant to paragraph (8) of that definition. Under the Standardized Approach, a 600 percent risk weight applies to these exposures. The agencies should eliminate the separate risk weighting for equity exposures to leveraged investment firms.

The rationales for our recommendation in Section VI.C.1 above apply here. The current full look-through approach and the proposed full and alternative modified look-through approaches are designed to capture the leverage of investment funds, making a separate risk weight category for leveraged investment firms unnecessary. It is also unclear what amount of leverage constitutes "greater than immaterial leverage," causing an exposure to an investment firm to fall under this separate risk weight category. In addition, neither the Basel standard, the UK nor the EU have this separate category of risk weighting.

The agencies have provided no evidence that a heightened risk weight is justified, whether it be the proposed 1,250 percent risk weight or the current 600 percent risk weight. The separate risk weight category for exposures to leveraged investment firms is unnecessary and should be eliminated. This would improve the clarity and coherence of the capital rules, while also making them more risk-sensitive and simpler.

**D. Any final rule should clarify that BOLI/COLI separate accounts are not market risk covered positions and provide banks flexibility to treat certain equity exposures to investment funds as banking book exposures.<sup>281</sup>**

BOLI/COLI products are life insurance policy contracts that protect banks against the loss of certain employees. If they are managed as separate accounts the capital rules require them to be treated as investments in investment funds. Banks have no intent to trade these policies; in fact, selling them would have adverse tax consequences. BOLI/COLI separate accounts are used to fund employee benefits and are therefore similar to the proposal's specific exclusions from the scope of market risk covered position for equity positions arising from deferred compensation plans, employee stock ownership plans and

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<sup>280</sup> Clause 10(i) of the definition of traditional securitization should exclude an equity exposure to an investment fund or any exposure to a company where all or substantially all its assets are financial assets and that has no material liabilities. This would keep equity exposures to investment funds out of the securitization framework, and it would also keep non-equity exposures to non-leveraged funds out of the securitization framework, consistent with the current boundaries of the various approaches in the capital rules.

<sup>281</sup> The comment letter on the proposal submitted by the International Swaps and Derivatives Association, Inc. and the Securities Industry and Financial Markets Association likewise addresses these points with respect to BOLI/COLI and equity exposures to investment funds, and we urge the agencies to consider the recommendations therein.

retirement plans.<sup>282</sup> Under the proposal, Section 140(a)(2) (which corresponds to Section 51(a)(2) of the current Standardized Approach) would require a bank to treat a separate account *as if it were* an equity exposure in an investment fund for purposes of the RWA framework for equity exposures. There is no corresponding provision in the market risk capital requirements in proposed Subpart F. Neither the proposed definition of market risk covered position nor any other aspect of Subpart F would address separate accounts or would require that they be treated like investment funds for purposes of calculating market RWAs. This aspect of the proposal correctly reflects that BOLI/COLI separate accounts, which are held without trading intent, should not be covered positions both due to the lack of trading intent and because a bank’s ability to apply the look-through approaches to BOLI/COLI separate accounts under the banking book rules does not mean it would be able to apply the look-through approach under the trading book rules, given the more stringent requirements to use the trading book’s look-through approach. The proposed rules text is not, however, without some ambiguity. Proposed Section 140(a)(2) treats separate accounts as investment funds for purposes of calculating equity RWAs, and the proposed definition of market risk covered position generally includes equity positions in investment funds unless excluded. To eliminate any ambiguity, BOLI/COLI separate accounts should be expressly excluded from the definition of market risk covered position.

With respect to seed capital investments, including those in regulated investment funds undertaken as a normal part of the asset management function of banks, the proposal includes in the definition of market risk covered position, without regard to whether they are trading positions, exposures to investment funds with respect to which the bank has access to the prospectus, partnership agreement or similar contracts defining its permissible investments and investment limits and is able to use the look-through approach for market risk capital or obtains daily price quotes for the investment fund.<sup>283</sup> Seed capital investments undertaken by bank asset management groups are not held for trading purposes. Seed capital investments are made to support new investment fund products for clients and are of a limited size and duration. Banks should therefore have the option, provided they can demonstrate and document a lack of trading intent, to calculate their exposure to seed capital investments using banking book rules, including equity RWAs under proposed Sections 140 and 142, instead of the trading book rules in Subpart F.

**E. Hedge pair treatment should be retained in the Expanded Risk-Based Approach.**

Under the current simple risk weight approach, the effective portion of a hedge pair receives a 100 percent risk weight. The Expanded Risk-Based Approach does not include this treatment. A 100 percent risk weight for the effective portion of a hedge pair would align the capital framework with risk, underlying economics and effective risk management practices and avoid undue increases in the costs of hedging activities.

The preamble to the proposal notes that the agencies removed the hedge pair treatment because most exposures eligible for the treatment would be addressed under the market risk capital framework.<sup>284</sup> Although the proposal would expand the scope of “covered positions” subject to market risk capital requirements and therefore affect the extent to which publicly traded equity exposures are subject to risk weighting under the simple risk weight approach, banks would continue to have banking book equity

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<sup>282</sup> See § \_\_.202(b).

<sup>283</sup> § \_\_.202(b).

<sup>284</sup> See 88 Fed. Reg. at 64,077.

exposures that are either publicly traded or have returns that are primarily based on a publicly traded equity exposure.

For example, Visa B shares are held by many banks.<sup>285</sup> These shares are not publicly traded and are generally not considered market risk covered positions. Visa A shares, however, are publicly traded, and many banks hedge Visa B shares with Visa A shares, which generally eliminates the market risk associated with the positions. Visa B shares are fully convertible into Visa A shares at the ultimately published ratio. Therefore, a stock hedge plus conversion ratio swap protection for any future ratio changes fully eliminates the equity market risk associated with the positions. Removing the current hedge pair treatment would significantly increase the RWAs for Visa B shares in a manner that is inconsistent with the actual risk exposure associated with these positions and associated hedges.<sup>286</sup>

Another example relates to equity positions that arise from employee compensation plans, such as deferred compensation programs. Banks often hedge those obligations to their employees with exposures designed to provide returns that mirror the obligations that are owed to the employees. Per the market risk covered position definition under Section 202, the exposures arising from deferred compensation plans are not considered market risk covered positions and therefore would be subject to the equity exposure calculation in the banking book. However, the hedges generally would reference publicly traded equity positions and therefore could be interpreted to qualify as market risk covered positions. As with other exposures to investment funds described above, banks should have the option to calculate their exposure on equity positions that arise from employee compensation plans, including any associated hedges, using banking book rules or trading book rules.<sup>287</sup>

The agencies justify removal of hedge pair treatment by claiming that it is not necessary, but these examples demonstrate otherwise. The absence of recognition of hedge pairs does not align with risk, underlying economics or effective risk management practices and increases the cost of risk-mitigating hedging activities. The agencies should therefore implement the hedge pair treatment in the Expanded Risk-Based Approach.

**VII. The credit risk mitigation framework under the Expanded Risk-Based Approach does not appropriately account for the risk reduction achieved through various risk-mitigating transactions and structures and should be revised.**

A number of aspects of the proposal would have the effect of making hedging against credit risk

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<sup>285</sup> In 2007 in connection with its initial public offering, Visa issued Class B common stock (so-called Visa B shares) to mostly U.S. financial institution clients of Visa. The purpose of the Visa B shares was to protect other common stockholders of Visa from certain litigation. The Visa B shares cannot be sold until that litigation is resolved. See Visa, *Information on Visa's potential exchange offer program* (Sept. 13, 2023), available at <https://usa.visa.com/visa-everywhere/blog/bdp/2023/09/12/information-on-visas-1694546403362.html>.

<sup>286</sup> More specifically, the proposal's increased risk weights and removal of the hedge-pair treatment would increase capital requirements by at least 5.5 times, through the 400 percent risk weight assigned to the Visa B shares and the 250 percent risk weight assigned to the Visa A hedge.

<sup>287</sup> We support the recommendation in the letter submitted by ISDA and SIFMA that banks should have the option to treat equity positions arising from employee compensation plans, along with their hedges, as market risk covered positions.

more costly and difficult for banks than under the current rules:

- The increase in the risk weights applicable to exposures to other banks as compared to the Standardized Approach would make protection from another bank less beneficial.<sup>288</sup>
- Collateral in the form of GSE and PSE securities would be subject to the same market price volatility haircuts and minimum haircut floors as general corporate securities despite the fact that they pose significantly less credit risk than corporate securities and serve important public functions.
- A corporate debt security would only be recognized as financial collateral if its issuer (or its parent) has a publicly traded security outstanding. This would significantly reduce the number of issuers whose debt securities could be recognized as financial collateral.
- Increasing the  $p$  parameter from 0.5 to one would increase the RWA amount for synthetic securitizations, which are important credit risk mitigation tools.
- The traditional and synthetic securitization frameworks prevent recognition of valuable credit risk mitigants, such as securitizations in which the underlying exposures are legally isolated from the bank though not de-recognized for accounting purposes, as well as credit-linked notes.
- The elimination of hedge pair treatment for equity exposures would likewise increase the RWA amount for the equity exposures and related hedges.<sup>289</sup>

These aspects of the proposal increase the costs of hedging by increasing the RWA amounts associated with certain hedging activities or decreasing the benefits from hedging as in certain instances hedges would not be recognized as credit risk mitigants. As a policy matter, the bank capital framework should reflect the risk mitigating benefits of hedging.

Throughout this letter, we have provided recommendations to better align the capital framework with the risk mitigation effects of hedging. In addition, the comment letter on the proposal submitted by the International Swaps and Derivatives Association, Inc. ("ISDA") and the Securities Industry and Financial Markets Association ("SIFMA") and the comment letter submitted by the Structured Finance Association ("SFA") address these and other aspects of the credit risk mitigation framework. We support the recommendations from ISDA, SIFMA and SFA on that framework and urge the agencies to implement our recommendations and those in the ISDA/SIFMA and SFA letters to appropriately recognize risk mitigation activities in the capital framework.

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<sup>288</sup> See Sections IV.A.4 and IV.A.5 for our recommendations regarding the risk weights applicable to exposures to banks.

<sup>289</sup> See Section VI.E for our recommendation to retain hedge pair treatment in the Expanded Risk-Based Approach.

**A. Cash proceeds and cash collateral that are not technically “cash on deposit” should be recognized as financial collateral.**

Under both the Standardized Approach and the proposed Expanded Risk-Based Approach, “financial collateral” would not include cash proceeds or cash collateral that is not “cash on deposit.”<sup>290</sup>

Cash proceeds and collateral warrant inclusion in the definition of “financial collateral” based on risk. For example, with respect to the cash proceeds of credit-linked notes and the cash proceeds of a pre-funded guarantee, the protection provider gives the bank the cash proceeds at the beginning of the transaction. Because the bank owns the cash proceeds outright, and the protection provider fully performs its payment obligations at the inception of the transaction, cash proceeds are no less effective as a credit risk mitigant than an arrangement involving a pledge of collateral. If a bank receives cash upfront, the bank has no exposure to a potential failure of the protection provider to perform on its obligations.

The Federal Reserve has recognized that cash proceeds from credit-linked notes serve the same purpose as “financial collateral.”<sup>291</sup> Allowing recognition of the credit risk mitigation benefits of cash proceeds would make the capital framework more risk-sensitive. The treatment of credit-linked notes would also align with the Basel framework<sup>292</sup> and implementation in other jurisdictions. The proposal provides no analysis to support its contrary approach.

**B. Consistent with the current Advanced Approaches, an eligible guarantee or eligible credit derivative should be recognized even if not issued by an eligible guarantor.**

For eligible guarantees and eligible credit derivatives, the proposal would only allow banks to substitute the risk weight of eligible guarantors for the risk weight applicable to the hedged exposure.<sup>293</sup> Under the current Advanced Approaches, an eligible guarantee need not be issued by an eligible guarantor in order to be recognized except in the context of the securitization framework.<sup>294</sup>

Guarantees and credit derivatives provided by persons or entities other than those that meet the definition of “eligible guarantor” still provide credit risk mitigation benefits. Limiting eligible guarantees to those provided by eligible guarantors would fail to recognize those benefits. The current Advanced Approaches do not require an eligible guarantee to be provided by an eligible guarantor other than in the case of securitization exposures. Indeed, in 2014 the agencies revised the definition of “eligible guarantee” to remove the eligible guarantor requirement for all guarantees other than securitizations under the Advanced Approaches. In the proposal for the revised definition, the agencies noted that the eligible guarantor requirement had “inadvertently limited the recognition of guarantees of wholesale exposures under the Advanced Approaches and that these guarantees should continue to qualify as credit risk

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<sup>290</sup> See 12 C.F.R. §§ 3.2; 217.2; 324.2.

<sup>291</sup> See, e.g., Board of Governors of the Federal Reserve, “Letter from Ann Misback to Luigi L. DeGhenghi, Esq.,” (Sept. 29, 2023) (approving treatment of credit-linked notes as a synthetic securitization where the only criterion to be treated as such that was not met was “the credit protection [was] pre-funded rather than backed by collateral”), available at [https://www.federalreserve.gov/supervisionreg/legalinterpretations/bhc\\_changeincontrol20230929.pdf](https://www.federalreserve.gov/supervisionreg/legalinterpretations/bhc_changeincontrol20230929.pdf).

<sup>292</sup> See Basel framework, 22.34, note 3.

<sup>293</sup> See 88 Fed. Reg. at 64,059, note 116.

<sup>294</sup> *Id.*

mitigants for purposes of the Advanced Approaches because they provide credit enhancement.”<sup>295</sup> The agencies have not explained why departing from this position in the Expanded Risk-Based Approach (which replaces the Advanced Approaches) would improve the risk-sensitivity of the capital framework.

Under the current Standardized Approach, an eligible guarantee must be made by an eligible guarantor and an eligible credit derivative must also be from an eligible guarantor.<sup>296</sup> However, the Standardized Approach, unlike the current Advanced Approaches and the proposed Expanded Risk-Based Approach, does not provide for variation in risk weights for counterparties that are not eligible guarantors. This variation in risk weights allows for appropriate risk-sensitivity without the eligible guarantor requirement. Consistent with the current Advanced Approaches, the “eligible guarantor” requirement in the context of the Expanded Risk-Based Approach should not be adopted.

Further, the eligible guarantor requirement would restrict the ability of banks to recognize the credit risk mitigation benefits of guarantees and other risk-mitigating transactions with insurance and reinsurance companies, in particular as compared to foreign banks that are subject to capital rules that have no such restriction. There is no discussion in the proposal analyzing the risk mitigation benefits of transactions involving insurance or reinsurance companies or the competitive effects of applying the eligible guarantor requirement in the context of the Expanded Risk-Based Approach. In addition, the eligible guarantor requirement would also unnecessarily restrict banks’ ability to recognize guarantees and credit derivatives fully collateralized by financial collateral if provided by an eligible guarantor. In these cases, the identity of the guarantor is irrelevant so long as the collateral is sufficient to cover the guarantee or credit derivative.

**C. For purposes of both the Standardized and Expanded Risk-Based Approaches, the simple approach should recognize the risk-mitigating benefits of collateral when the bank may exercise its rights to the collateral in a timely manner, even if potentially subject to a stay.**

Consistent with the simple approach in the Standardized Approach,<sup>297</sup> in order to apply the simple approach, Section 121(b)(1)(ii)(A) would require collateral to be subject to a “collateral agreement” for the life of the exposure. An agreement cannot qualify as a “collateral agreement” if a bank’s exercise of rights under the agreement may be stayed or avoided under applicable law, including insolvency law (subject to exceptions for stays under special resolution regimes).<sup>298</sup> Consistent with the Basel framework,<sup>299</sup> banks should be allowed to recognize the risk mitigation benefits of collateral when they may exercise their rights to the collateral in a timely manner, even if potentially subject to a stay.

This aspect of the definition applying to the simple approach and, as proposed, the Expanded Risk-Based Approach appears to be an unintended aspect of the current rules. The definition of “collateral agreement” was first used in connection with the implementation of Basel II with respect to the internal

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<sup>295</sup> Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule, Proposed Revisions to the Definition of Eligible Guarantee, 79 Fed. Reg. 24,618, 24,620 (May 1, 2014).

<sup>296</sup> See “eligible guarantee” and “eligible credit derivative” in 12 C.F.R. §§ 3.2; 217.2; 324.2.

<sup>297</sup> See 12 C.F.R. §§ 3.37(b)(1)(ii)(A); 217.37(b)(1)(ii)(A); 324.37(b)(1)(ii)(A).

<sup>298</sup> See 12 C.F.R. §§ 3.2; 217.2; 324.2.

<sup>299</sup> See Basel framework, 22.26.

models methodology for determining capital requirements relating to collateralized, over-the-counter derivatives, repo-style transactions and eligible margin loans.<sup>300</sup> The 2012 proposal of the current Standardized Approach used the undefined (for purposes of the simple approach) term “collateral agreement” and did not discuss any technical aspect of the definition.<sup>301</sup> The alternative to the simple approach, the collateral haircut approach, applies only to financial collateral securing over-the-counter derivatives, repo-style transactions and eligible margin loans, each of which would typically be a qualified financial contract (“QFC”) or otherwise eligible for various safe harbors under applicable insolvency law, such as those providing for exemptions from potential stays. The simple approach was meant to be an alternative to the collateral haircut approach, applying to financial collateral securing “any exposure.”<sup>302</sup> In 2012, the Basel III proposal moved the pre-existing definition of collateral agreement, designed for the internal models methodology, to Section 2 of the current rules, thereby applying it to the simple approach, even though it seems contrary to the purpose of the simple approach – to provide an alternative when the collateral haircut approach does not apply – and there is no evidence that it was intended to apply to the simple approach or that the implications were considered.<sup>303</sup>

Because of this potentially unintended extension of the definition and the broad application of stays under insolvency law, such as the U.S. Bankruptcy Code, the Federal Deposit Insurance Act (“FDIA”) and Title II of the Dodd-Frank Act, banks generally cannot recognize collateral securing loans, even if a bank has a first-priority, perfected security interest in collateral, unless the transactions qualify for specified exclusions and safe harbors. As a general matter, only certain specified types of financial contracts, such as commodity contracts, forward contracts, securities contracts, swap agreements and repurchase/reverse repurchase agreements, could qualify as “collateral agreements” in practice.

The possibility that a stay might delay a bank’s ability to exercise its rights with regard to collateral does not mean that the collateral provides no risk mitigation benefits. The Basel framework recognizes this and permits recognition of collateral where the collateral agreement provides that “the bank has the right to liquidate or take legal possession of [the collateral], in a timely manner, in the event of the default, insolvency or bankruptcy . . . of the counterparty.”<sup>304</sup> The credit risk mitigation benefits of collateral should be recognized when a bank may exercise its rights to the collateral in a timely manner, even if it might be subject to a stay. This would improve the risk-sensitivity of the capital rules, consistent with the stated goal of the proposal.<sup>305</sup>

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<sup>300</sup> See 72 Fed. Reg. 69,288, 69,349 (Dec. 7, 2007).

<sup>301</sup> See Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; Proposed Rule, 77 Fed. Reg. 52,888, 52,909 (Aug. 30, 2012).

<sup>302</sup> See *id.* at 52,958.

<sup>303</sup> See 77 Fed. Reg. 52,792, 52,797 (Aug. 30, 2012) (“Under the revised structure, each agency’s capital regulations would include definitions in subpart A.”).

<sup>304</sup> Basel framework, 22.26.

<sup>305</sup> 88 Fed. Reg. at 64,028 (“The revisions set forth in the proposal would improve the calculation of risk-based capital requirements to better reflect the risks of these banks’ exposures.”).

**D. The simple approach should allow for the recognition of the risk mitigation benefits of collateral with a maturity or currency mismatch, subject to an adjustment.**

The proposed simple approach would not allow recognition of the risk mitigation benefits of financial collateral that has a maturity or currency mismatch with the collateralized exposure.<sup>306</sup> The proposed rule would allow recognition of the risk mitigation benefits of eligible guarantees and eligible credit derivatives with maturity or currency mismatches, adjusting for the mismatch.<sup>307</sup> Like guarantees and credit derivatives with a maturity or currency mismatch, collateral with such mismatches still provides credit mitigation benefits, and those benefits should be recognized.

In addition, the Basel framework allows for recognition of the credit risk mitigation benefits of financial collateral with a currency mismatch under all approaches and allows for recognition of the risk mitigation benefits of financial collateral with a maturity mismatch under approaches other than the simple approach.<sup>308</sup> The agencies have provided no analysis or justification for this departure. Allowing for the recognition of the risk mitigation benefits of collateral with a maturity or currency mismatch, adjusting for such mismatch, would improve the proposal's risk-sensitivity and alignment with international standards.

The most consistent way to apply the adjustment for such a currency mismatch would be to align with the approach provided for currency mismatches related to eligible credit derivatives and guarantees under existing Section 36(f) and proposed Section 120(f). In the context of the simple approach this would mean that in the case of a currency mismatch between the collateral and the exposure, the fair value of the financial collateral that would be eligible to change the risk weight of the exposure would be reduced by the following haircut:

$$H_{FX} = 8\% \sqrt{\frac{T_M}{10}}$$

$T_M$  equals the greater of 10 and the number of days between revaluation, which would be capped at 125 days, given the requirement under the simple approach that the collateral would have to be revalued at least every six months.

**E. When an eligible guarantee, eligible credit derivative or a credit risk mitigant covers multiple hedged exposures, the average residual maturity of the hedged exposures should be used as the residual maturity of all the hedged exposures in calculating the maturity mismatch adjustment.**

Under proposed Section 134(b), when an eligible guarantee, eligible credit derivative or credit risk mitigant covers a netting set with hedged exposures that have different residual maturities, the proposal would require banks to use the longest residual maturity of any of the hedged exposures as the residual maturity of all the hedged exposures in making the adjustment for a maturity mismatch. Consistent with the approach in the proposed CVA framework,<sup>309</sup> when an eligible guarantee, eligible credit derivative or

<sup>306</sup> See § \_\_.121(b)(1)(ii).

<sup>307</sup> See § \_\_.120(d) and (f).

<sup>308</sup> See Basel framework, 22.11; 22.12; 22.15.

<sup>309</sup> See § \_\_.222(a)(2)(iii)(C).

credit risk mitigant covers multiple hedged exposures, the average residual maturity of the hedged exposures should be used as the residual maturity of all the hedged exposures in calculating the maturity mismatch adjustment.

**F. The requirement that a qualifying master netting agreement not contain a walkaway clause should be read consistently with the FDIA and the Dodd-Frank Act.**

The proposal would revise the definition of “Qualifying Master Netting Agreement” (“QMNA”) in the Federal Reserve’s and OCC’s capital rules to require that the agreement not contain a “walkaway clause,” which the proposed rule would describe as “a provision that permits a non-defaulting counterparty to make a lower payment than it otherwise would make under the agreement, or no payment at all, to a defaulter or the estate of the defaulter, even if the defaulter or the estate of the defaulter is a net creditor under the agreement.”<sup>310</sup> The agencies explain that this would correct an error when the Federal Reserve’s and OCC’s capital rules were amended to reflect the QFC stay rule.<sup>311</sup> The prohibition on walkaway clauses was first introduced in the capital framework in 1994, following a change to the Basel framework to recognize netting.<sup>312</sup> The Federal Reserve explained at the time that the prohibition on walkaway clauses reflected its view that “walkaway clauses do not reduce credit risk.”

U.S. insolvency law also addresses walkaway clauses. Specifically, the conservatorship and receivership provisions of the FDIA and Title II (the orderly liquidation authority for covered financial companies) of the Dodd-Frank Act address the unenforceability of these clauses against the FDIC (as receiver or conservator), such that a counterparty cannot terminate a contract or otherwise excuse or modify its obligation to perform under a contract solely by virtue of the bank’s entry into receivership/conservatorship.

The description of “walkaway clause” in the proposal does not, however, match the statutory definition of “walkaway clause” in the FDIA and Title II of the Dodd-Frank Act, which contain provisions relating to the treatment of contracts, including QFCs, entered into before the appointment of the FDIC as conservator or receiver.<sup>313</sup> The FDIA provides that no walkaway clause in a QFC of an insured depository institution in default is enforceable. “Walkaway clause” is defined as:

any provision in a qualified financial contract that suspends, conditions, or extinguishes a payment obligation of a party, in whole or in part, or does not create a payment obligation of a party that would otherwise exist, solely because of such party’s status as a nondefaulting party in connection with the insolvency of an insured depository institution that is a party to the contract or the appointment of or exercise of rights by a conservator or receiver of such depository institution, and not as a result of a party’s exercise of any right to offset, setoff, or net obligations that exist

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<sup>310</sup> 88 Fed. Reg. at 64,296.

<sup>311</sup> See 88 Fed. Reg. at 64,172, 64,296 and 64,311 (Sept. 18, 2023). The proposal would not revise the FDIC’s capital rules because the definition of QMNA in the FDIC’s rules currently includes a corresponding provision. See 12 C.F.R. § 324.2.

<sup>312</sup> See Capital; Capital Adequacy Guidelines, 59 Fed. Reg. 62,987 (Dec. 7, 1994).

<sup>313</sup> 12 U.S.C. § 1821(e)(8)(G)(iii); see also 12 U.S.C. § 5390(c)(8)(F)(iii) (substantively identical definition of “walkaway clause” in Title II of the Dodd-Frank Act).

under the contract, any other contract between these parties, or applicable law.<sup>314</sup>

This provision of the FDIA and the nearly identical provision in Title II of the Dodd Frank Act applicable to covered financial companies thus protect an insured depository institution or covered financial company from the enforceability of a walkaway clause in a QFC with a counterparty in the event the insured depository institution or covered financial company becomes insolvent or enters into receivership or conservatorship under the FDIA or Title II.

The provision relating to walkaway clauses that the agencies propose to reinsert in the definition of QMNA in the Federal Reserve's and OCC's capital rules, by contrast, would, absent clarification, operate as a prohibition on the inclusion of such a clause in a contract that a bank seeks to recognize as a QMNA, regardless of whether it would be the bank itself that seeks to enforce it against a counterparty and regardless of whether the laws applicable to the transaction make such walkaway clauses enforceable or unenforceable. In the regulatory capital context, it is unclear what policy objective would be served if a bank could not include a walkaway clause in a QMNA, where the bank (rather than the counterparty) can invoke the clause (*i.e.*, a one-way walkaway clause in favor of a bank) or where the counterparty or the bank can invoke the clause for reasons of default other than insolvency (*i.e.*, a two-way walkaway clause applicable only if a party fails to perform its obligations). In the first instance, the bank would be advantaged contractually by such a one-way walkaway clause. In the second instance, since the two-way walkaway clause could not be invoked in the event of the bank's entry into insolvency proceedings, and since the inclusion of a walkaway clause in favor of the bank's counterparty would not be enforceable against the bank under an FDIA or Title II receivership or conservatorship proceeding anyway, there would be no reason for an outright prohibition on such a walkaway clause.<sup>315</sup> The FDIA and Title II define walkaway clause in a manner that is designed to protect banks, and the FDIA and Title II definition should apply in the context of the capital rules.

A complete prohibition on two-way walkaway clauses would impair the ability of many utility providers and municipalities to hedge risks associated with electrical power generation and transmission. In 2001, when Enron failed, many utility providers were unable to exit their contracts when Enron failed to deliver electricity. Enron had long-dated contracts to supply electricity to municipal power suppliers. These trades were in the money for Enron as the high prices at which they sold the electricity had come down significantly. When Enron filed for bankruptcy in December of 2001, many of these supply contracts automatically terminated as they had ISDA-style automatic early termination provisions ("AETs"). These provisions immediately crystallized a payable from the utility to Enron which the utility, lacking access to revolving or other credit facilities, could not pay immediately. Even where AETs did not apply, utilities were reluctant to terminate the agreements and crystalize an immediate payable given their liquidity constraints. Under the agreements, utilities had to pay termination damages not only for delivered but as yet unpaid for power *but also* for the mark-to-market pricing on *future* deliveries. During the bankruptcy

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<sup>314</sup> 12 U.S.C. § 1821(e)(8)(G)(iii) (emphasis added).

<sup>315</sup> The ability of a bank to recognize the benefits of netting under a QMNA for purposes of the capital rules is subject to the operational criteria for the recognition of QMNAs, which require a bank to conduct a sufficient legal review to be able to conclude with a well-founded basis that (i) the agreement meets the relevant definitional requirements of a QMNA, and (ii) in the event of a legal challenge (including one resulting from a default or from a receivership, insolvency, liquidation or similar proceeding), the relevant court and administrative authorities would find the agreement to be legal, valid, binding and enforceable under the law of the relevant jurisdictions (which would necessarily include the laws of the jurisdiction governing the counterparty's insolvency proceedings). See 12 C.F.R. §§ 3.3(d); 217.3(d); 324.3(d).

proceedings, Enron invoked AETs and attempted to collect damages for electrical power it never delivered. As a result, a number of utility providers also went bankrupt.<sup>316</sup> Post-Enron, utility providers have generally amended their agreements to allow them to walk away when a counterparty fails to deliver electricity without having to pay the crystallized value of the contract. Without these clauses, these providers would be subject to the same risks they faced with Enron, and the communities to whom they provide electricity would also be subject to costly charges for power or a lack of power. A broad prohibition on walkaway clauses could effectively prohibit large banks from helping utility providers hedge their risks due to the substantial increase in capital requirements if the banks cannot net contracts with utility providers. Utility providers would face increased costs of hedging, which would affect the costs of electrical power generation and ultimately the price consumers and business pay for power.

The agencies should clarify that the prohibition on walkaway clauses in the definition of QMNA would align with the statutory definition of walkaway clause in the FDIA and the Dodd-Frank Act and would permit both: (i) a one-way walkaway clause that only the bank could invoke against the counterparty and (ii) a two-way walkaway clause which, in the case of the bank's counterparty, can only be invoked by the counterparty in the event the bank fails to perform provisions under the agreement that are entirely within its control – such as failure to deliver a physical commodity – and which cannot be invoked by the counterparty in the event the bank enters into bankruptcy, receivership or similar proceedings. These walkaway clauses would not implicate the benefits, in mitigating credit risk, of a netting agreement and they would be consistent with the FDIA, the Dodd-Frank Act Title II provisions, and thus should not inhibit the bank's ability to satisfy the operational requirements for the recognition of QMNAs.

**VIII. The securitization framework under the Expanded Risk-Based Approach requires significant revision to appropriately reflect the risks associated with securitization exposures.**

The proposed securitization framework does not adequately reflect the risks associated with securitization exposures. For example, the operational criteria for traditional securitizations are not appropriately tied to the transfer of credit risk. In addition, the securitization standardized approach misstates risk in a number of ways, including the unjustified increase in the  $p$  factor from 0.5 to 1, which is particularly inappropriate with respect to those securitizations that meet certain criteria that indicate they pose less complex credit risk concerns.

The comment letter submitted by the SFA addresses the breadth of issues posed by the securitization framework in detail. We support SFA's recommendations and urge the agencies to adopt them.

**IX. The agencies should retain the 25 percent simplified deduction framework for Category III and IV banks.**

The proposal would remove the 25 percent simplified deduction framework for Category III and IV banks and require them to apply the 10 percent/15 percent deduction thresholds currently applicable to

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<sup>316</sup> See, e.g., Kurt Eichenwald, "Enron seeks millions for Power Never Delivered to Sierra Pacific," *The New York Times* (Oct. 6, 2003); Hal Bernton, "No easy escape from Enron; BPA may be stuck with costly contract," *The Seattle Times* (Feb. 8, 2002) (entered into the Congressional Record by Sen. Peter Fitzgerald, Senate Hearing 107-1138, Subcommittee On Consumer Affairs, Foreign Commerce and Tourism of the Committee On Commerce, Science, and Transportation, Examining Enron: Electricity Market Manipulation and the Effect on the Western States, April 11, 2002).

Category I and II banks with respect to, among other things, mortgage servicing assets, net of associated deferred tax liabilities; temporary difference DTAs, net of any related valuation allowances and net of deferred tax liabilities; and significant investments in the capital of unconsolidated financial institutions in the forms of common stock, net of associated deferred tax liabilities.<sup>317</sup> The current 25 percent deduction threshold was established by the agencies' recent capital simplification rule, which was the product of a multi-year review pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 and an extensive notice-and-comment rulemaking process.<sup>318</sup> The agencies should not simply abandon the 25 percent deduction threshold and revert to the more complex and burdensome framework for Category III and IV banks without reasonable explanation. As explained below, the proposed 10 percent/15 percent deduction thresholds, particularly with respect to temporary difference DTAs (*i.e.*, DTAs arising from temporary differences that a bank could not realize through net operating loss carrybacks ("NOL CB") but could only realize through future taxable income as of the regulatory capital calculation date),<sup>319</sup> is overly punitive and not justified. Therefore, we urge the agencies to retain the 25 percent deduction threshold for Category III and IV banks.

As a result of the adoption of the CECL framework, banks have higher allowances for credit losses.<sup>320</sup> Higher allowances for credit losses, in turn, increase temporary difference DTAs. The 10 percent/15 percent deduction thresholds were designed and calibrated prior to the implementation of CECL, when banks applied the incurred-loss methodology. Unrealized losses on AFS debt securities also increase DTAs. As a result, due to changes in accounting standards and prevailing market conditions, banks currently face significantly higher DTAs than when the 10 percent/15 percent deduction thresholds were calibrated. As a consequence, the 10 percent/15 percent deduction thresholds are overly conservative in light of current accounting standards and market conditions.<sup>321</sup> These impacts are particularly large for banks with significant consumer financing and credit card businesses, and the capital strain caused by the proposed changes could reduce their ability to provide credit, especially during periods of stress.

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<sup>317</sup> Category I and II banks must deduct from CET1 capital amounts of mortgage servicing assets, temporary difference DTAs and significant investments in the capital of unconsolidated financial institutions in the form of common stock that individually exceed 10 percent of the bank's CET1 capital minus certain deductions and adjustments. *See id.* at 64,036. Category I and II banks must also deduct from CET1 capital the aggregate amount of threshold items not deducted under the 10 percent deduction but that nevertheless exceeds 15 percent of the bank's CET1 capital minus certain deductions and adjustments. *See id.* at 64,037.

<sup>318</sup> *See* Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, 84 Fed. Reg. 35,234 (July 22, 2019).

<sup>319</sup> Following the enactment of a tax law on December 22, 2017, the agencies explained that DTAs are generally temporary difference DTAs subject to deduction thresholds because, for tax years beginning on or after January 1, 2018, the law generally removed the ability to use NOL CBs to recover taxes paid in prior tax years. *See* Board of Governors of the Federal Reserve, et al., "Interagency Statement on Accounting and Reporting Implications of the New Tax Law," (Jan. 18, 2018), *available at* <https://www.federalreserve.gov/supervisionreg/srletters/sr1802a1.pdf>.

<sup>320</sup> *See, e.g.*, Bert Loudis, et al., "New Accounting Framework Faces Its First Test: CECL During the Pandemic," FEDS Notes (Dec. 3, 2021), *available at* <https://www.federalreserve.gov/econres/notes/feds-notes/new-accounting-framework-faces-its-first-test-cecl-during-the-pandemic-20211203.html> (finding that the adoption of CECL "resulted in an immediate 37 percent increase in adopters' allowances" on Jan. 1, 2020).

<sup>321</sup> This is particularly true with respect to many Category III and IV banks that have business models with fewer activities to offset DTAs than Category I and II banks already subject to the lower threshold.

Moreover, overly conservative treatment of DTAs has unnecessarily procyclical impacts that would threaten, rather than strengthen, safety and soundness. DTAs typically increase during actual stress conditions when a bank realizes significant loan losses. Those stress conditions would also lead to significant increase in allowances for credit losses (and associated DTAs), which would, in turn, create additional stress on the bank's capital levels. This procyclicality arises not only in an actual downturn, but as a practical matter impacts capital levels at banks during normal economic times through the stress testing and SCB calculations. As noted above, the implementation of CECL exacerbates this concern. We recognize the agencies historically have been concerned with the ability of banks to realize DTAs against future taxable income, in particular the concern that a bank may not be able to realize the value of the DTAs under adverse financial conditions. We note, however, that the capital rules are premised upon banks as going concerns, not failed entities, and therefore the concern that future taxable income would not exist against which DTAs could be used or realized should not be a driving consideration, particularly with respect to DTAs arising from timing differences. In addition, DTAs on a bank's balance sheet are already subject to a "more-likely-than-not" to be realized valuation standard under GAAP with DTAs that are less than "more-likely-than-not" to be realized charged off to equity via a valuation allowance. Accordingly, any deduction of the DTAs from regulatory capital is already conservative, and further expanding the scope of deductions for Category III and IV banks by lowering the deduction threshold from 25 percent to 10 percent would be unwarranted and overly punitive.

Another driver of the increase of DTAs for Category III and IV banks is the proposed removal of the AOCI opt-out. Lowering the DTA deduction threshold concurrently with removing the AOCI opt-out would significantly and unjustifiably increase capital requirements for Category III and IV banks.

In light of the considerations above, the agencies should maintain, for Category III and IV banks, the current 25 percent deduction threshold for temporary difference DTAs. The agencies have previously recognized that a bank's ability to realize its temporary difference DTAs is "dependent on future taxable income" and, accordingly, the 25 percent deduction threshold, together with a 250 percent risk weight for non-deducted temporary difference DTAs, will "protect bank capital against the possibility that the bank would need to establish or increase valuation allowances for DTAs during periods of financial stress."<sup>322</sup> Recent events have not changed the realizability of temporary difference DTAs. During stress scenarios, the Federal Reserve already deducts from capital net operating losses and tax credit carryforwards and should not adjust the treatment of temporary difference DTAs. As an alternative to maintaining the 25 percent deduction threshold for temporary difference DTAs for Category III and IV banks, the agencies could allow ACL DTAs to be excluded from the regulatory capital deduction limitation. ACL DTAs are recoverable DTAs, and recognition of ACL DTAs occurs over a multi-year period, even during stress scenarios. During this multi-year period, ACL DTAs are recovered and more than offset by the associated loan interest income and fees of the portfolio. The implementation of CECL and changes to the U.S. tax code support a more favorable capital treatment for these exposures.

In addition, in the context of supervisory stress testing, the Federal Reserve should also allow the assumption of a two-year NOL CB for temporary difference DTAs (excluding NOLs and credit carryforwards) for U.S. federal tax purposes under stress scenarios. Congress frequently uses a NOL CB – either by reinstating it and/or expanding its carryback period – during stress scenarios as an anti-recessionary tax

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<sup>322</sup> 84 Fed. Reg. at 35,239. The agencies also recognized that the 25 percent deduction threshold may also "mitigate the adverse effects of potential increases in temporary difference DTAs stemming from CECL or from changes to the tax code." *Id.*

policy in order to provide liquidity to businesses during stress scenarios, which mirror the Federal Reserve's hypothetical stress scenarios under DFAST. For example, in response to the COVID-19 pandemic, Congress enacted the CARES Act, which, among other things, allowed firms to carry back losses in tax years covering 2018, 2019 and 2020 for up to five years and provided that NOL CBs could offset 100 percent of taxable income (*i.e.*, rather than 80 percent).<sup>323</sup>

If the agencies do not maintain the 25 percent deduction threshold for temporary difference DTAs for Category III and IV banks, they should (i) increase the aggregate 15 percent deduction threshold and (ii) separately apply the 10 percent deduction threshold to temporary DTAs related to the ACL and other temporary difference DTAs.

**X. Further changes to the definition of capital would cause unnecessary market disruptions and should not be adopted.**

Under the proposal, the definition of capital for Category III and IV banks would be aligned with the definition currently applicable for Category I and II banks. In addition to applying the capital deductions and minority interest treatment currently applicable to Category I and II banks, the proposal would, among other things, require Category III and IV banks to (i) recognize most elements of AOCI in regulatory capital and (ii) apply TLAC holdings deduction treatments. We provide recommendations with respect to these firms in Sections III.E, IX and X.A. To avoid significant and unnecessary market disruptions, the agencies should maintain the AOCI opt-out election for banks with less than \$100 billion in total assets and should not change the regulatory capital treatment of unrealized gains/losses on held-to-maturity ("HTM") securities that are not recorded in AOCI.

**A. The AOCI opt-out election for banks with less than \$100 billion in total assets should be maintained.**

The proposal would require Category III and IV banks to recognize unrealized gains/losses on AFS debt securities and most other elements of AOCI in regulatory capital, subject to a phase-in period, as discussed below. The proposal would not change the existing regulatory capital treatment of AOCI for Category I and II banks or for banks with less than \$100 billion in total assets. We support the proposed maintenance of the existing regulatory capital treatment for banks with less than \$100 billion in total assets.

When the agencies adopted their Basel III capital rules in 2013, they provided non-Advanced Approaches banks the ability to opt out of the requirement to recognize AOCI in regulatory capital because the volatility in regulatory capital that could result from the requirement to recognize most elements of AOCI in regulatory capital "could lead to significant difficulties in capital planning and asset-liability management."<sup>324</sup> The agencies also observed that the "tools used by larger, more complex banks for managing interest rate risk are not necessarily readily available for all banks."<sup>325</sup> The rationales for providing the AOCI opt-out election to non-Advanced Approaches banks continue to apply to banks with

<sup>323</sup> See Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (Mar. 27, 2020).

<sup>324</sup> Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018, 62,060 (Oct. 11, 2013).

<sup>325</sup> *Id.*

less than \$100 billion in total assets. Removing the AOCI opt-out election for these banks would (i) create inaccurate depictions of actual capital strength due to what are typically temporary changes in market interest rates; (ii) introduce volatility in capital ratios; and (iii) negatively affect banks' ability to hedge interest rate risk on their liabilities effectively and economically due to the costs of holding investment securities with longer maturities.

**B. The regulatory capital treatment of unrealized gains/losses on HTM securities that are not recorded in AOCI should remain unchanged.**

The proposal would not change the regulatory capital treatment of unrealized gains/losses on HTM securities that are not recorded in AOCI, but asks what “complementary measures” the agencies should consider regarding the regulatory capital treatment for securities held as HTM rather than AFS.<sup>326</sup> We strongly oppose including changes in the fair values of HTM securities within regulatory capital. We agree with the position expressed in the interagency letter to the Financial Accounting Standards Board (“FASB”) related to its 2010 proposal to reflect all financial instruments on the balance sheet at fair value.<sup>327</sup> Including fair value changes would: (i) create a fundamental and unwarranted break between GAAP and shareholders' equity and regulatory capital; (ii) be inconsistent with the economic exposure of a bank, as HTM classification reflects that a bank has the ability and intent to hold the security to maturity (any credit-related losses would be recognized in the ACL and therefore in regulatory capital under current accounting standards); (iii) have the paradoxical effect of providing a capital benefit for unrealized gains that are highly unlikely to be realized and that would generally be illusory; (iv) introduce unwarranted volatility in capital requirements, in particular during times of stress when there may be short-term market conditions that may result in large but temporary fluctuations in market value; (v) compel banks to shorten the duration of their debt securities portfolios; and (vi) create significant asymmetry in the treatment of loans and securities because changes in value for loans held for investment would not affect regulatory capital.<sup>328</sup> Such a requirement would also unnecessarily fragment interest rate risk management practices, which are typically performed on a holistic basis by financial institutions. Greater fragmentation would likely result in greater interest rate risk being transferred to the borrowers of loans. In addition, it is impractical for banks to hedge HTM securities because current accounting rules bar hedge accounting

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<sup>326</sup> 88 Fed. Reg. at 64,036.

<sup>327</sup> See Letter from Ben. S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Sheila C. Bair, Chairman, Federal Deposit Insurance Corporation, Debbie Matz, Chairman, National Credit Union Administration, John Walsh, Acting Comptroller, Office of the Comptroller of the Currency and John E. Bowman, Acting Director, Office of Thrift Supervision, to Russell G. Golden, Technical Director, FASB (Sept. 30, 2010), available at <https://www.fasb.org/Page/ShowPdf?path=1402-%201810-100%20FRS%20FDIC%20NCUA%20OCC%20OTS%20BEN%20S.%20BERNANKE.pdf>.

<sup>328</sup> The existing accounting treatment of loans is appropriate because it accurately reflects the business of banking, as the 2010 interagency letter to FASB recognized. See *id.* at 3 (“Fair value measurement may be appropriate for an institution employing a business strategy that seeks to profit from short-term price movements. However, the primary business strategy for the vast majority of financial institutions that we supervise is a long-term strategy for financial intermediation that is based on maturity transformation. This largely involves funding long-term loans with deposits backed by deposit insurance protection, and earning an interest margin on the difference between the interest income generated and the associated funding costs. Fair value measurement would not faithfully reflect these institutions' financial position because their business strategies are not predicated on the sale or transfer of these instruments, but rather the collection and payment of contractual cash flows.”).

treatment for interest rate hedging of HTM securities.

Historically, interest rate risk, including on HTM debt securities, has been addressed through supervision rather than regulation. To the extent the agencies would like to address interest rate risk through regulation, they should develop a framework that does so in an appropriate and coherent manner that provides benefits that outweigh the costs on banks and the broader economy.

**XI. The Federal Reserve should address the impacts of the proposal on the single-counterparty credit limits (“SCCL”) framework by providing a transition period for the SCCL rule and revising the SCCL rule to provide that minimum haircuts do not apply under that framework.**

The proposal would require all covered banks to use the standardized approach for counterparty credit risk to calculate their SCCL, which the agencies estimate would “generally result in higher derivative exposures than the internal models method.”<sup>329</sup> A transition period for purposes of the SCCL rule and revising the SCCL rule to provide that any minimum haircuts do not apply under that framework would mitigate the impact of this change on covered banks.

**A. The Federal Reserve should provide a transition period for purposes of the SCCL rule to avoid potential disruptive effects on financial markets.**

Under the proposal, banks would not be able to use internal models-based approaches for credit risk, which would affect the SCCL rule. As proposed, the change for SCCL purposes would be immediate upon the effectiveness of a final rule. To avoid potential disruptive effects on financial markets as a result of abrupt changes in the measurement of counterparty credit exposures under the SCCL rule, the Federal Reserve should provide a transition period for purposes of the SCCL rule.

There are two potential ways to implement a transition period. First, the Federal Reserve could permit banks that currently use internal models-based approaches for SCCL purposes to continue to do so during a two-year transition period following the effective date of a final rule. Alternatively, the same factors that apply for determining RWAs under the Expanded Risk-Based Approach could apply for purposes of calculating credit exposure under the SCCL rule if a bank must transition from using internal models to a standardized approach that would apply for purposes of determining RWAs under the Expanded Risk-Based Approach. For example, if a bank were required to use a standardized approach instead of an internal models-based approach for valuing a securities financing transaction or derivative, from July 1, 2025 through June 30, 2026, credit exposure for the SCCL rule would be the amount calculated using the applicable standardized approach, multiplied by the same factor applicable under the transition provisions for calculating RWAs under the Expanded Risk-Based Approach (*i.e.*, 80 percent in the proposal).

**B. The Federal Reserve should revise the SCCL rule to provide that any minimum haircuts do not apply under that framework.**

The Federal Reserve should revise the SCCL rule to provide that any minimum haircuts do not apply because the SCCL framework is designed for a different regulatory purpose than the proposed minimum haircuts.

Currently, a bank subject to the SCCL rules can use any method the bank is authorized to use under

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<sup>329</sup> *Id.* at 64,171.

either Subpart D or the current models-based Subpart E of the capital rules for purposes of calculating its gross credit exposure in respect of an SFT or derivative transactions under the SCCL.<sup>330</sup> Under the proposal, a bank could no longer use Subpart D. Rather, the bank would be required to calculate its gross credit exposure for SFTs and derivative transactions for purposes of the SCCL using the methods set forth in the Expanded Risk-Based Approach.<sup>331</sup> The Federal Reserve should revise the SCCL rules to expressly provide that SFTs should be valued using the method specified in proposed Section 121(c) (which includes the revised collateral haircut method under the Expanded Risk-Based Approach), and that proposed Section 121(d) (the minimum haircut floors), if implemented, are not applicable in the context of SCCL calculations. This revision would reflect that the proposed minimum haircut floors were not intended to apply when a bank determines the valuation of an SFT for SCCL purposes.

The SCCL is unrelated to the stated purpose of the minimum haircut floors. The SCCL is intended to “limit the risks that the failure of any individual firm could pose to [large U.S. and foreign banking holding companies and nonbank financial companies].”<sup>332</sup> By contrast, the proposed minimum haircuts are “intended to limit the build-up of excessive leverage outside the banking system and reduce the cyclicity of such leverage, thereby limiting risk to the lending bank and the banking system.”<sup>333</sup> The SCCL framework provides a methodology that must be used to calculate gross credit exposure on SFTs, and the SCCL serves separate and distinct policy purposes from the stated objective for the proposed minimum haircut floors.

**XII. Reasonable transition periods that allow banks to phase in the new requirements should be adopted.**

The agencies should make the following changes that would allow banks to phase in the complex new requirements in a manner that minimizes operational disruptions.

**A. The proposed three-year transition periods for the recognition of AOCI in regulatory capital and the calculation of RWAs under the Expanded Risk-Based Approach should be extended.**

The proposal would establish three-year transition periods for (i) the requirement that Category III and IV banks recognize most elements of AOCI in regulatory capital, and (ii) the calculation of RWAs under the Expanded Risk-Based Approach,<sup>334</sup> and all other aspects would apply in full on the effective date of a final rule. The phase-in period relating to the recognition of AOCI in regulatory capital should be extended over a longer period, and the phase-in period relating to the calculation of RWAs under the Expanded Risk-Based Approach should be less compressed, starting with a lower transitional factor.

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<sup>330</sup> See 12 C.F.R. §§ 252.73(a)(4), 252.73(a)(7); 252.173(a)(4), 252.173(a)(7).

<sup>331</sup> See 88 Fed. Reg. at 64,031, 64,326 and 64,327.

<sup>332</sup> Single-Counterparty Credit Limits for Bank Holding Companies and Foreign Banking Organizations, 83 Fed. Reg. 38,460, 38,492 (Aug. 6, 2018).

<sup>333</sup> 88 Fed. Reg. at 64, 063.

<sup>334</sup> 88 Fed. Reg. at 64,166. The recognition of AOCI would be phased in on a 25 percent, 50 percent, 75 percent and 100 percent schedule, and the calculation of RWAs under the Expanded Risk-Based Approach would be phased in on an 80 percent, 85 percent, 90 percent and 100 percent schedule. See *id.*

1. A longer phase-in period for Category III and IV banks to recognize most elements of AOCI in regulatory capital should be established.

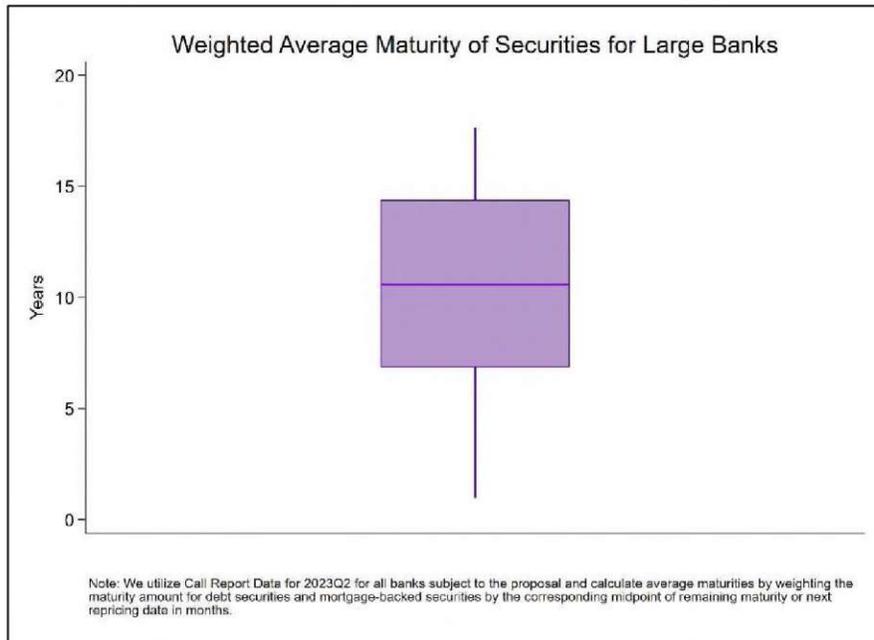
A longer phase-in period for the recognition of AOCI in regulatory capital would reduce volatility in regulatory capital calculations attributable to legacy positions in AFS debt securities with unrealized losses, as those securities ultimately mature over time. As the agencies have previously recognized, including unrealized losses on AFS debt securities in regulatory capital calculations “could introduce substantial volatility in a bank’s regulatory capital ratios” and, among other things, “could mean that fluctuations in a benchmark interest rate could lead to changes in their [prompt corrective action] categories from quarter to quarter.”<sup>335</sup> In light of the typical duration of investment securities portfolios, and in order to enable banks to better manage this volatility, the phase-in period should be over five years. Specifically, we analyzed the weighted-average repricing/maturity period (in years) of securities held by banks subject to the proposal.<sup>336</sup> Our findings indicate that the weighted average maturity of U.S. Treasury securities and Agency MBS is about 10.6 years. As shown in the chart below, the median weighted average maturities across all banks subject to the proposal is 10.6 years, with the first quartile at 6.9 years and the third quartile at 14.4 years.

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<sup>335</sup> 78 Fed. Reg. at 62,058.

<sup>336</sup> Banks report maturity and repricing data for securities in memoranda items on Call Report Schedule RC-B. For example, U.S. Treasury securities reported on the Call Report as having a remaining maturity or next repricing date of more than three months but less than or equal to 12 months were assumed to have a repricing/maturity period of 7.5 months, the midpoint of the (3, 12) interval. Securities reported with remaining maturity or next repricing date of three months or less were assumed to have a repricing/maturity period of two months; securities reported with remaining maturity or next repricing date of over one year through three years were assumed to have a repricing/maturity of period of two years; securities reported with remaining maturity or next repricing date of over three years through five years were assumed to have a repricing/maturity of period of four years; securities reported with remaining maturity or next repricing date of over five years and less than or equal to 15 years were assumed to have a repricing/maturity period of 10 years; securities reported as having remaining maturity or next repricing date of over 15 years were assumed to have a repricing/maturity period of 20 years.

Figure 26



The phase-in schedule should be more back-weighted, instead of ratable, so that the transition period is more reflective of anticipated cash flows on investment securities. As securities approach their stated maturities, all else equal, the market price will trend toward par – a phenomenon commonly referred to as the pull to par. For example, with a five-year phase-in period, the agencies could establish a schedule of 10 percent, 20 percent, 35 percent, 50 percent, 70 percent and 100 percent. In addition, the phase-in period for the recognition of AOCI in regulatory capital should be available for a bank that moves into Category II as a result of the proposed changes to the measurement of cross-jurisdictional activity under the Federal Reserve’s notice of proposed rulemaking to amend the GSIB surcharge methodology.<sup>337</sup>

2. The agencies should establish a less compressed phase-in period for the calculation of RWAs under the Expanded Risk-Based Approach.

A less compressed phase-in schedule for the calculation of RWAs under the Expanded Risk-Based Approach – such as 70 percent, 80 percent, 90 percent and 100 percent – would facilitate the ability of banks to adjust to the higher capital requirements under the Expanded Risk-Based Approach and also better mitigate the potential adverse impact of the proposal on the cost and availability of credit and their ability to provide liquidity to market participants. A lower initial starting point for the phase-in schedule would also recognize the significant systems build required for banks to manage their balance sheets under the Expanded Risk-Based Approach.

**B. A transition period for the inclusion of market RWAs under the Standardized Approach should be provided.**

The proposal would not provide a transition period for the inclusion of market RWAs using the

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<sup>337</sup> See Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15), 88 Fed. Reg. 60,385, 60,394 (Sept. 1, 2023).

FRTB-based market risk capital rule under the Standardized Approach. The agencies acknowledge that capital requirements determined by the new market risk capital rule are expected to “increase substantially.”<sup>338</sup> A transition period for the calculation of market RWAs as a component of the Standardized Approach would serve similar policy objectives as the transition period for the calculation of RWAs under the Expanded Risk-Based Approach: providing banks sufficient time to adjust to the new requirements while minimizing the potential impact that the proposal could have on the ability of banks to facilitate their customers’ hedging activities and to provide liquidity to market participants.

**C. The agencies should, to the extent they do not retain the 25 percent simplified capital deduction framework for Category III and IV banks, provide a transition period to apply the revised capital deductions.**

The proposal would require Category III and IV banks to apply the capital deductions and minority interest treatments that are currently applicable only to Category I and II banks but does not include a transition period. As discussed above, we urge the agencies to retain the current 25 percent simplified capital deduction framework for Category III and IV banks. To the extent the agencies do not retain the 25 percent simplified capital deduction framework for Category III and IV banks, they should provide a transition period for Category III and IV banks to apply these capital deductions and minority interest treatments. The agencies should also provide a transition period for a bank that would move into Category II as a result of the proposed changes to the measurement of cross-jurisdictional activity under the Federal Reserve’s notice of proposed rulemaking to amend the GSIB surcharge methodology. A transition period for capital deductions would serve the same policy objective as the other proposed transition periods. Absent a transition period, many Category III and IV banks would experience abrupt and significant increases in deductions, in particular deductions attributable to DTAs. According to the Member QIS, the proposed changes to the capital deduction framework would reduce Category III and IV firms’ CET1 capital ratios by 2.3 percentage points. The changes to deduction thresholds alone, largely attributable to DTAs, would lead to a 0.4 percentage point decrease for these same firms. The elimination of the AOCI filter accounts for the remaining 1.9 percentage point decline in the aggregate CET1 capital ratio of those banks.<sup>339</sup>

The transition period for capital deductions should be structured so that, during each year of the transition period, a bank would be required to recognize only a specified portion of the deduction that would otherwise result from the application of the 10 percent/15 percent deduction thresholds instead of the 25 percent deduction threshold currently applicable. The agencies should adopt a phase-in schedule of 20 percent, 40 percent, 60 percent, 80 percent and 100 percent, such that during year one, a Category III or IV bank – or a bank that moves into Category II as a result of the proposed amendments to the measurement of cross-jurisdictional activity<sup>340</sup> – would recognize 100 percent of the amount in excess of the 25 percent deduction threshold, plus 20 percent of the amount that would be deducted under the 10 percent/15 percent deduction thresholds, but not the 25 percent threshold, and so on. At the beginning of

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<sup>338</sup> 88 Fed. Reg. at 64,167.

<sup>339</sup> This corresponds to the decreases in regulatory capital resulting from the changes to the definition of capital for Category III and IV firms without factoring in the changes to RWAs in the proposal (with the exception of items that were previously risk-weighted but are now deducted from regulatory capital as a result of changes to the definition of capital). For a description of the study, including the study population and methodology, see Appendix 16.

<sup>340</sup> If the agencies do not apply the same transition period to banks that move into Category II as a result of this change, they should nonetheless provide some transition period for these banks.

year five, the bank would apply the 10 percent/15 percent deduction thresholds without any adjustment.

**D. The agencies should provide a transition period for a bank that crosses the \$100 billion asset threshold and becomes subject to the Expanded Risk-Based Approach as a result of an acquisition.**

Under the proposal, the Expanded Risk-Based Approach would apply to all Category I through IV banks and would not include a transition period for a bank upon first crossing the \$100 billion asset threshold and becoming subject to the capital framework. The absence of such a transition period could present implementation challenges, particularly in the context of an acquisition that would result in a bank with less than \$100 billion in assets crossing the threshold. Several members of Congress and other stakeholders have raised concerns that the proposal would “push the U.S. banking system further toward a ‘barbell’ banking system,”<sup>341</sup> and Vice Chair for Supervision Barr has addressed these concerns in part by noting that the agencies “want to make sure that regulation encourages [the] continued diversification of the financial system.”<sup>342</sup>

A transition period would mitigate these concerns by smoothing the implementation burdens for banks that grow through acquisitions and facilitating the ability of smaller banks to grow, including through acquisitions.

**E. Expectations regarding how current Advanced Approaches banks should phase out the use of their advanced systems should be clarified.**

Banks subject to the Advanced Approaches have devoted substantial resources to developing, implementing and maintaining their advanced systems for purposes of current Subpart E. The proposal would eliminate the models-based approaches in Subpart E with respect to credit risk, operational risk and CVA risk, but it does not provide guidance on how the agencies expect banks to phase out these advanced systems. Rather, the proposal vaguely states: “[l]arge banks should employ internal modeling capabilities as appropriate for the complexity of their activities.”<sup>343</sup>

The expectations for Advanced Approaches banks are unclear. For example, the agencies should explain whether banks could commence the phase-out process upon issuance of a final rule in advance of the effective date of the Expanded Risk-Based Approach. Permitting the commencement of a phase-out process upon issuance of a final rule would allow these banks to allocate resources otherwise used to maintain the advanced systems to implementation of the Expanded Risk-Based Approach and other compliance or risk-management purposes.

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<sup>341</sup> See Letter from House Financial Services Committee Chairman Patrick McHenry to Michael S. Barr, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, and Michael J. Hsu, Acting Comptroller of the Currency (Sept. 13, 2023), available at [https://financialservices.house.gov/uploadedfiles/2023-09-13\\_fsc\\_gop\\_letter\\_to\\_bank\\_regulators.pdf](https://financialservices.house.gov/uploadedfiles/2023-09-13_fsc_gop_letter_to_bank_regulators.pdf).

<sup>342</sup> Kyle Campbell, “Fed’s top regulator calls for discount window readiness by banks,” Am. Banker (Oct. 2, 2023, 4:47 PM), available at <https://www.americanbanker.com/news/feds-top-regulator-calls-for-discount-window-readiness-by-banks>.

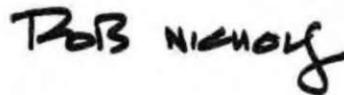
<sup>343</sup> 88 Fed. Reg. at 64,032.

The Bank Policy Institute and the American Bankers Association appreciate the opportunity to comment on the proposal. If you have any questions, please contact Francisco Covas, Executive Vice President and Head of Research, Bank Policy Institute by email at [Francisco.Covas@BPI.com](mailto:Francisco.Covas@BPI.com) or Hu Benton, Senior Vice President and Policy Counsel, American Bankers Association by email at [hbenton@aba.com](mailto:hbenton@aba.com).

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'GB', with a long horizontal flourish extending to the right.

Greg Baer  
President and CEO  
*Bank Policy Institute*

A handwritten signature in black ink, reading 'ROB NICHOLS' in a stylized, blocky font.

Rob Nichols  
President and CEO  
*American Bankers Association*



