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Confidential Treatment Requested

Ms. Ann E. Misback
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Mr. James P. Sheesley
Attention: Comments/Legal OES (RIN 3064-AF29)
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

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

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (Docket No. OCC—2023—0008; FRB Docket No. R-1813; FDIC RIN 3064—AF29)

To whom it may concern:

UBS appreciates the opportunity to respond to the regulatory capital rule proposal[1] (Proposal) issued by the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the Agencies). UBS supports the Agencies' overarching goal of updating capital requirements to make them consistent with international standards issued by the Basel Committee on Banking Supervision (BCBS) and aligned with proposals under consideration in other jurisdictions. Given that the stated objective in developing the Basel 3 standards was not to increase capital requirements but rather to improve risk sensitivity and reduce capital variability,[2] we have concerns about whether the Proposal actually achieves this goal. We therefore consider that changes to the Proposal are warranted to align requirements not only with international standards but also with the risk profiles of covered firms. In particular, our letter focuses on challenges and potential solutions with respect to the proposed operational risk capital charge, which, by the Agencies' own estimates, represents almost 90 percent of the overall increase in risk-weighted assets (RWAs) under the Proposal.[3]

In addition to this letter, UBS agrees with the issues raised and supports the solutions offered by the Bank Policy Institute (BPI), the American Bankers Association (ABA), the Institute of International Bankers (IIB), the Securities Industry and Financial Markets Association (SIFMA), the International Swaps and

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[1] Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity Federal Register / Vol. 88, No. 179 dtd. September 18, 2023

[2] Mario Draghi, Chair of the GHOS and President of the European Central Bank, Statement at the GHOS Press Conference (Dec. 7, 2017) ("The focus of the exercise was not to increase capital. As a matter of fact, the GHOS almost a year ago endorsed this review by the Basel Committee, provided it wouldn't create a significant capital increase in the aggregate of the banking system"); *see also* Agencies, "U.S. banking agencies support conclusion of reforms to international capital standards" (Dec. 7, 2017) ("The reforms finalized today are intended to improve risk sensitivity, reduce regulatory capital variability, and level the playing field among internationally active banks.").

[3] Proposal at 64168

Derivatives Association (ISDA), Investment Company Institute (ICI) and the Futures Industry Association (FIA) in their respective responses to the Proposal.

Operational Risk Framework

The Proposal introduces a new standardized risk charge for operational risk, whereby a firm's capital requirement is a function of a banking organization's business income (a business indicator component or BI) and its historical loss data (its internal loss multiplier or ILM). The BI is itself a product of three different components: an interest, lease, and dividend component; a services component; and a financial component. The ILM functions as a scaling factor based on the ratio of a bank's historical operational losses relative to its BI. Under the proposal, a bank's operational risk capital requirement would increase as historical operational losses increase; however, when firms implement enhanced internal control frameworks, the mitigating impact would only be felt with reduced operational losses in the future.

We have concerns with how the operational risk capital charge is determined and calibrated. In particular, we are concerned with the disproportionate charges that would be associated with fee-based businesses like wealth management and asset management. In addition, the Proposal's floor on the ILM differs from the international standard and the proposed requirements of other jurisdictions (e.g., the UK and EU have proposed an ILM of 1).

Punitive Treatment of Low-Risk, Fee-based Businesses

The proposed treatment of fee income-based businesses in the services component is unduly punitive. Unlike the calculation of interest income under the BI, there is no offsetting of revenues with applicable expenses in the calculation of BI, nor is there any cap on the amount of fees included in the calculation. This leads to an overcapitalization of banks that have significant fee-generating business activities.

This undue treatment of fee-based business models, while not newly identified, was never resolved in the BCBS deliberations, and carried into the Proposal. The 2016 BCBS consultative document highlighted that the business indicator calculation would overcapitalize banks with high fee revenues: "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."[4] The same consultative document sought to address this problem by proposing a cap to mitigate the impact. However, the final BCBS standard did not retain the proposed cap.

This challenge also was highlighted by several agency officials during consideration of the Proposal. FRB Governor Bowman indicated that the Proposal penalizes banks with diversified business models that include fee-oriented businesses.[5] Many fee-based business activities are not balance-sheet intensive and do not pose significant credit or market risks. While any business poses operational risk, the Agencies don't provide evidence that fee-based businesses pose higher risks and therefore justify greater capital requirements under the Proposal. Indeed, advisory-based services such as wealth management and asset management where firms provide advice to clients on assets that they own generally pose low operational risks as evidenced by long-term historical data of losses.

[4] Basel Committee on Banking Supervision, Consultative Document: Standardised Measurement Approach for Operational Risk (March 2016), at 4, *available at* https://www.bis.org/bcbs/publ/d355.pdf

[5] "Today's proposal also adopts a punitive treatment for noninterest and fee-based income through the proposed operational risk requirements, exacerbated by the use of an internal loss multiplier that may result in an excessive overall capital charge for operational risk. Diversification 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." *Available at:* https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm

The punitive treatment of these fee-based businesses would hurt retail customers by raising the cost and reducing the availability of essential financial services like wealth management and asset management that they rely upon to save and invest for retirement or a child's education. Further, a dramatic increase in capital requirements associated with these activities would be problematic given that these businesses feature many nonbank competitors that are outside the regulatory perimeter and therefore are not subject to capital requirements. The Agencies' goal of financial stability is not enhanced by disincentivizing greater diversification in bank business models, while also encouraging more activities to migrate to lesser-regulated nonbank sectors.

The Agencies have a variety of ways in which they can address this serious problem. They can cap the fee income component, which is consistent with the treatment of other components in BI, and, as noted, was the proposed approach in the BCBS's 2016 consultation document. They also can net commission and fee income with expenses (which also is consistent with the treatment of other BI components). They also can make the business indicator more risk sensitive by applying risk weights to specific lines of business. Lastly, the Agencies should allow for the exclusion of income from intercompany services and transfer pricing provided to foreign banking organization (FBO) affiliates of an intermediate holding company (IHC) as the proposed treatment would further overstate the services component for IHCs but would be eliminated in consolidation for domestic banking organizations.

Exclusion of Historical Losses and the Internal Loss Multiplier (ILM) Floor

In the Proposal, the Agencies state that "higher historical operational losses are associated with higher future operational risk exposure"[6] and that "supervisory experience also suggests that operational risk management deficiencies can be persistent, which can often result in operational losses."[7] However, the Agencies provide no data or analysis to support these assertions. Indeed, a recent industry analysis shows that the Proposal's operational risk charge is disproportionate to actual historical loss data. That analysis showed that average annual operational losses dating back to 2003 were below 30 percent of the proposed requirement and that actual annual losses for any given bank rarely exceeded 30 percent.[8]

While the Proposal would allow firms to request supervisory approval to exclude operational loss events such as those related to an exited business, the Agencies presuppose that the approval of such exclusions would be "rare" and do not provide clear criteria on how supervisors would make such determinations.[9] Operational risks are idiosyncratic in nature and the most effective way to address these types of risks is through effective risk management systems and controls, which regulators oversee through supervision.[10] Capital requirements, while an important backstop measure, need to be calibrated in a way that provides appropriate incentives for investment in risk controls and systems.

Furthermore, the Agencies seem to acknowledge the limited efficacy of longer-term data in the proposed calculation of the BI. In the BI, the Agencies propose using three-year rolling averages for relevant inputs because a longer period would "reduce its responsiveness to changes in a bank's activities, which could in turn weaken the relationship between the capital requirements and the bank's

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6 Proposal at 64086
7 Proposal at 64086
8 Report, "Basel III and standardised approaches to capital," O.R.X (Oct. 2023), available at https://orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023.
9 Proposal at 64088
10 As FDIC Vice Chairman Travis Hill indicated, "…operational risk is an amorphous concept, a catch-all category that encompasses a large and highly variable set of risks, ranging from fraud to bad behavior to overzealous enforcement agencies to cyber attacks to asteroids." *Available at:* https://www.fdic.gov/news/speeches/2023/spjul2723b.html#:~:text=I%20have%20concerns%20with%20the,capital%20framework%20for%20large%20banks; As FRB Governor Michel Bowman indicated, "…it would be preferable to address risk management concerns through improved supervision, demanding prompt remediation of risk management shortcomings, and taking enforcement actions when firms fail to remediate known issues." *Available at:* https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm

risk profile."[11] Additionally, two economists at the FRB recently concluded in a research paper that past losses are only predictive up to three years and far shorter than the proposed 10-year period.[12]

Under the BCBS standard, the ILM can be based on historical losses or national authorities can use discretion to neutralize the impact of historical operational risks losses by setting the ILM equal to 1. The EU[13] and UK[14] have sought to exercise that national discretion by proposing that the ILM be set at 1. The Proposal, however, would set a floor of 1 for the ILM, which would be overly conservative and not risk sensitive as the ILM only could move upwards if a firm has unfavorable historical loss experience but could not move below 1 when a firm has implemented effective control standards.

To address the range of concerns in relation to the ILM, we believe the Agencies should make adjustments to the overall ILM framework. In particular, they could set the ILM equal to 1 to align with approaches proposed in other jurisdictions or eliminate the floor to make the ILM more responsive to risk-reducing measures taken by firms. With respect to improving risk sensitivity, we believe that the Agencies should provide greater clarity and consistency on the recognition of loss event exclusions (whether for the exiting a line of business or for improvements in internal controls) from the ILM calculation.

Other Issues

Overlap with Stress Testing

There is overlap between the Proposal and the FRB's stress capital charge (SCB), which also captures operational risk. Notably, in the 2023 DFAST, the FRB estimated $185 billion of losses (out of total stressed losses of $540 billion) related to operational risk across the 23 institutions subject to the supervisory stress test. Those stressed losses, which are captured in the 23 institutions' stress capital buffer and are therefore part of their capital requirements, represent a third of total stressed capital. Yet, as FRB Governor Waller points out, total capital due to operational risk could more than double under the Proposal.[15] This problem is not unique to operational risk (it is an issue with market and CVA risk requirements as well). We urge the Agencies to take measures to address potential overlaps between how the standardized approach and the supervisory stress test regime account for specific risks for both operational and market risks.

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11 Proposal at 64083

12 "[W]e investigate how far back past losses help predict future losses and find that past losses are informative up to three years prior." Filippo Curti and Marco Migueis, *The Information Value of Past Losses in Operational Risk*, J. OPERATIONAL RISK, VOL. 18, No.2 (June 12, 2023), *available at* https://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID3770790_code1830154.pdf?abstractid=3353446&mirid=1.

13 The EU stated: "[I]n order to ensure a level playing field within the Union and to simplify the calculation of operational risk capital, those discretions are exercised in a harmonised manner by disregarding historical operational loss data for all institutions." EU Explanatory Memorandum, *available at* https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52021PC0664

14 In making this decision, the UK Prudential Regulatory Authority stated that it "proposed to exercise the national discretion included in the Basel 3.1 standards to set the ILM equal to 1 to remove the mechanical link to historical internal operational risk losses." It further stated that it "considers that a mechanical link to past losses is inappropriate for a number of reasons, including that the 'fat-tailed' nature of operational risk losses – being infrequent but very large – means past events (particularly over a lengthy historical period) are generally not good predictors of future losses." UK Implementation Document, *available at* https://www.bankofengland.co.uk/prudential-regulation/publication/2023/december/implementation-of-the-basel-3-1-standards-near-final-policy-statement-part-1

15 "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 risk weighted assets that are nearly $2 trillion higher than in the current U.S. standardized stack, which could lead to a more than doubling of the operational risk capital required relative to just the stress test-based requirement." Statement by Christopher Waller, Governor, FRB, July 27, 2023, *available at* https://www.federalreserve.gov/newsevents/pressreleases/waller-statement-20230727.htm

We are concerned that the overlap also would make capital requirements more pro-cyclical. The clear and stated objective of the annual stress testing process is that "large banks are able to lend to households and businesses even in a severe recession."[16] It reflects a prevailing view that capital resiliency should be measured by a firm's capacity to withstand a severe stress scenario and continue to execute its operating plan without negative consequences to financial stability. A banking organization that experiences a stress event would need to replenish its capital to continue its normal operating activities without disruption to its clients. However, if it faced increased operating costs in the form of higher RWAs under the Proposal in combination with the variable costs of annual supervisor-run stress tests, it would have a very difficult time raising additional capital from investors seeking an economic return. Without the ability to raise sufficient capital, the firm would need to curtail activities and reduce availability of financial services to households, businesses, and other clients.

Residential Real Estate Risk-weighting

The BCBS standard provides the opportunity for national supervisors to evaluate and adjust risk weights for exposures secured by residential real estate as well as other exposures based on default experience and other factors such as market price stability. The Agencies provide no analysis of loss histories for residential real estate based upon loan to value (LTV) in the Proposal. Instead, the Proposal essentially would apply a supplemental weighting requirement of 20% relative to the BCBS standards for this asset class across all risk-weight categories (e.g., LTV≤50% is weighted 20% within the BCBS standard whereas the same category is risk-weighted 40% under the Proposal).[17] Given the lack of evidence supporting this incremental requirement and given that these exposures also are coved under stress testing, we think the Agencies should revert to the BCBS standard.

Timing of Regulatory Capital Adjustments

Under current capital rules, certain banking organizations must deduct certain assets (e.g., investments in the capital of unconsolidated financial institutions, mortgage servicing assets, and temporary difference deferred tax assets) from common equity Tier 1 capital if they, by category, exceed a 25 percent threshold. Under the Proposal, Category III and IV banking organizations would need to deduct these items from capital and otherwise would be subject to the same capital deductions applicable to Category I and II banking organizations. Whether or not these changes are appropriate, we are concerned that they are not subject to an appropriate transition period similar to the capital treatment of accumulated other comprehensive income (AOCI). Given that such adjustments are aimed at aligning capital across all Categories, the Agencies should apply consistent transitions and allow for the same three-year transition for capital adjustments that is provided for the treatment of AOCI.[18]

Calculation of Capital Ratios and Floors

The Proposal would increase the complexity of regulatory capital requirements by layering additional measures in which covered firms need to calculate risk weighted assets. Whereas covered firms currently are subject to one risk-based capital calculation, they would need to calculate risk weighted assets in three different ways under the Proposal. Specifically, they would be subject to a standardized approach, an enhanced risk-based approach, and a market risk output floor. For the IHCs of FBOs, these requirements would be incremental to home country capital requirements of their parent companies. As these changes subject covered firms to increased complexity and administrative burden in the US, their

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16 FRB, 2023 Stress Test Scenarios, *available at* https://www.federalreserve.gov/publications/2023-Stress-Test-Scenarios.htm

17 Proposal at 64048 and Basel Committee Calculation of RWA for credit risk section 20.82 Residential Real Estate exposures, https://www.bis.org/basel_framework/chapter/CRE/20.htm?inforce=20230101&published=20221208

18 As the Agencies' own analysis shows, these "threshold changes would dominate for the U.S. intermediate holding companies of foreign bank organizations" and that the proposed changes in the definition of regulatory capital would lead to a 13.2% increase in their CET1 requirements and a 9.7% increase in leverage capital requirements for these firms. Proposal at 64171.

purpose is not clear. With the new changes from the enhanced risk-based approach, the standardized approach will never be a binding capital constraint. Given the unclear benefits of the proposed approach and the increased processing burden to execute multiple calculations, we hope the Agencies would revert to one calculation under the new enhanced risk-based approach.

National Treatment

Overall, the Proposal would increase the binding common equity tier 1 (CET1) capital requirements, including minimums and buffers, of large holding companies by an estimated 16 percent.[19] However, the Agencies provided no quantitative evidence that this capital increase actually would achieve their stated policy goal of increasing resiliency and offered no meaningful analysis within the Proposal's preamble regarding its impact on the availability and cost of financial services and its overall economic impact.[20]

More specifically, the approach taken has a particularly disproportionate impact on the US operations of FBOs largely due to the predominance of fee-based activities within their IHCs. Based upon the proposed changes, the Agencies estimate a 14% increase in CET1 capital requirements for IHCs in Categories III and IV whereas it estimates a 6% increase for similarly situated domestic banking organizations.[21] Indeed, the estimated impact of increased CET1 requirements for Category III and IV IHCs is much closer to that of Category I and II banking organizations (19% estimated increase) than it is to that of more comparably-sized domestic peers. This inconsistent treatment is contrary to longstanding principles of US banking law regarding national treatment and competitive equality. It also does not reflect the reduced US footprint and risk profile of FBOs in the US. Given these disparities, the Agencies should undertake additional analyses to identify the root causes (including the new operational risk charge and its undue treatment of fee-income businesses) of this significant increase in capital requirements for IHCs and evaluate whether it is appropriate or warranted.[22]

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We appreciate the opportunity to provide comments and would welcome additional discussions on the topics raised in this letter.

Yours sincerely,

Naureen Hassan
President Americas

Markus Ronner
Group Chief Compliance and Governance Officer

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19 Proposal at 64169
20 Proposal at 64167
21 Proposal at 64169
22 Based on an analysis using 2021 data, the Agencies estimate that RWAs would increase 25% for Category III and IV IHCs (this was equal to the estimated increase for Category I and II banking organizations and was far higher than the estimated 6% increase for domestic Category III and IV banking organizations). The Agencies also estimate that changes to the definition of regulatory capital would result in Category III IHCs facing a 13.2% increase in their CET1 requirements and 9.7% increase in leverage capital requirements compared to respective increases of 4.6% and 3.8% for domestic firms in Category III. Proposal at 64168, 64171.