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

January 16, 2024

Subject: Notice of Proposed Rulemaking (NPR), Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (Docket IDs OCC-2023-0008, FRS R-1813, and FDIC-RIN 3064-AF29)

Dear Ms. Misback, Mr. McDonough, and Mr. Sheesley:

Americans for Financial Reform Education Fund (AFREF) appreciates the opportunity to comment on the Federal Deposit Insurance Fund (FDIC), the Board of Governors of the Federal Reserve System (Board) and the Office of the Comptroller of the Currency's (OCC) Notice of Proposed Rulemaking, Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity,<sup>1</sup> hereafter the large bank capital proposal. AFREF is a nonpartisan and nonprofit coalition of more than 200 civil rights, consumer, labor, business, investor, faith-based, and civic and community groups dedicated to advocating for policies that shape a financial sector that serves workers, communities, and the real economy, and provides a foundation for advancing economic and racial justice.

The agencies issued this proposal alongside the Board's notice of proposed rulemaking, Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report

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<sup>1</sup> Notice of Proposed Rulemaking. "[Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity](#)." Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the FDIC. 88 Fed. Reg. 179. September 18, 2023 at 64028 et seq.

(FR Y-15),<sup>2</sup> for which AFREF has submitted a separate comment letter. These proposals are urgently needed to increase large banks' safety and soundness, strengthen financial system stability, and preserve ordinary people's access to financial services, particularly for underserved communities.

The large bank capital proposal aims to implement the final components of the Basel III agreement, commonly called Basel III Endgame. The Basel Committee on Banking Supervision is an international prudential banking regulatory framework agreed to by 28 countries including the United States to promote cooperation on banking regulatory matters and encourage banking supervisory approaches to strengthen safety and soundness of the global financial system and financial institutions to prevent global financial crises.<sup>3</sup> Each country pursues their own regulatory approaches to provide comparable safety and soundness regulations. The Basel Committee began its third iteration of banking regulatory standards (Basel III) after the 2008 global financial crisis demonstrated the flaws in the prior global framework (Basel II). The Basel III framework includes capital, leverage, and liquidity requirements that individual member countries committed to implement in 2017 (the "endgame" agreement).<sup>4</sup>

This current proposal revises the risk-based capital framework to improve the risk sensitivity of risk-weighted assets (RWA) for firms with at least \$100 billion in total assets and for firms with significant trading activities. The proposal would strengthen certain capital standards and expand Basel III applicability to include banking organizations in the same total assets band as Silicon Valley Bank (SVB), also referred to as Category IV firms in the Fed's large banking organization tailored supervision framework.<sup>5</sup> The failures of SVB, Signature Bank and First Republic in 2023 — the second, third and fourth largest bank failures in U.S. history, respectively — reinforced the need for these enhanced capital requirements.

The proposal would reduce large banking organizations' reliance on their own internal models for estimating their compliance with capital requirements and require them instead to use more risk-sensitive standardized approaches for market, operational, and credit risk as well as credit valuation adjustment (CVA) exposures. These changes would raise capital requirements for the largest firms by an estimated 19 percent and increase capital requirements for regional banks by an estimated 6 percent.<sup>6</sup> The current Basel III Endgame bank capital proposal has been under consideration since 2017.

The proposal, once finalized, would improve the comprehensiveness, consistency, and transparency of the capital requirements applicable to large banking firms. Robustly implementing the Basel III Endgame and restoring enhanced capital requirements for Category IV banks — removed by the banking regulators' rulemaking during the Trump administration — would result in more adequate capital levels that more accurately reflect the large banking organization's risk-taking activities and systemic risk profiles. AFREF has called for stronger capital and leverage requirements for large banks since 2012<sup>7</sup> and supports the agencies' finalization of this proposal.

The proposed changes are essential to bolster large bank capital and the financial stability of the U.S. economy. A bank's capital is the stock or equity that represents the owners' stake in the bank. Capital — defined as the

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<sup>2</sup> Notice of Proposed Rulemaking. "Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)." 88 Fed. Reg. 169. September 1, 2023, 64169 et seq.

<sup>3</sup> See Bank for International Settlements. [Basel Committee Charter](#). Accessed December 2023.

<sup>4</sup> Schroeder, Pete. "[Explainer: What is the 'Basel II endgame' and why are banks worked up about it.](#)" *Reuters*. July 24, 2023.

<sup>5</sup> Board of Governors Federal Reserve, "[Tailoring visual.](#)"

<sup>6</sup> Notice of Proposed Rulemaking. "[Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity.](#)" Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the FDIC. 88 Fed. Reg. 179. September 18, 2023 at 64169.

<sup>7</sup> Americans for Financial Reform Education Fund. "[Comment Letter on Basel III Regulatory Capital Rules.](#)" October 22, 2012.

difference between the value of a firm’s assets and the value of its liabilities – helps a bank avoid insolvency and failure. A bank’s capital gives it the ability to sustainably absorb losses in its business lines and still operate to provide critical services to the economy, depositors, businesses, and communities.<sup>8</sup> Banks without the capital reserves necessary to weather economic storms can put the economic fortunes of depositors, customers, and communities in jeopardy. The Board’s Vice Chair for Bank Supervision and Regulation Michael Barr summarized:

[N]othing is more basic to the safety and soundness of banks and the stability of the financial system than capital. Capital enables firms to serve as a source of strength to the economy by continuing to lend through good times and bad. To continue to perform these functions, banks must have a sufficient level of capital to ensure that they can absorb losses and continue operations during times of stress in the financial system when losses may be significant.<sup>9</sup>

Adequate capital levels are important for financial stability and for economic and racial justice. The set of capital reforms in these proposals are essential to prevent further large bank failures and financial system instability, because of undercapitalized banks pursuing outsized risk-taking. The inadequacy of capital standards has led to a speculative mindset and large-scale boom and bust financial cycles in recent history that have hurt families, communities, and businesses and disproportionately reduced wealth and access to credit for communities of color, rural, and other underserved communities, and small businesses. The proposed capital changes to measurement of credit risk, operational risk, market risk, and derivatives-related credit-valuation adjustment (CVA) risk together reduce reliance on firms’ internal risk models and introduce more risk sensitive standardized models. These improvements are urgently needed to prevent undercapitalized banks from putting peoples’ and businesses’ livelihoods and financial wellbeing at risk.

The 2023 bank failures underlined that a bank can appear well capitalized on paper but still lack sufficient capital cushion to weather severe financial or non-financial stresses.<sup>10</sup> As Vice Chair Barr elaborated recently, “[o]ne factor motivating the depositors’ run on SVB was a concern about its solvency, particularly the risk that the unrealized losses on the firm’s securities holdings were larger than the firm’s equity. This loss of confidence underscores the importance of credible and robust capital standards and prompt regulatory intervention.”<sup>11</sup> Maintaining a robust capital cushion is particularly important for large banks in the face of novel risks, for example, those related to advancements in digitalization, social media, and incorporation of machine learning and artificial intelligence into banking, which may accelerate the speed of depositor runs and contagion.

AFREF supports the goals of the proposed regulations to strengthen the capital of banking firms to improve the safety and soundness of depository institutions, enhance the resilience and stability of the financial system, and reduce the likelihood of future financial crises that disproportionately harm Black and Latinx families and communities. This comment lays out key components and benefits of the proposed rule including reduced reliance on internal models; more reliable assessments of credit, market, and operational risk; and the strengthening of capital standards for the Silicon Valley Bank-sized Category IV institutions. It describes the benefits of stronger capital standards to financial stability and reducing the likelihood and severity of financial crises that disproportionately harm Black, Latinx, and lower-income families. Finally, the comment addresses specific

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<sup>8</sup> Congressional Research Services, Belts and Suspenders: Analysis of Large Bank Capital Standards July 26, 2023. <https://crsreports.congress.gov/product/pdf/R/R47634>.

<sup>9</sup> Barr, Michael S. Vice Chair for Supervision. Board of Governors of the Federal Reserve. [Speech]. “[Making the Financial System Safer and Fairer.](#)” Brookings Institution. Washington, DC. September 7, 2022.

<sup>10</sup> See Starling Insights. “[Explore Confidence Cushions.](#)” June 7, 2023.

<sup>11</sup> Barr, Michael S. Vice Chair for Supervision. Board of Governors of the Federal Reserve System. “[Letter Regarding Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank.](#)” April 28, 2023.

questions raised in the notice of proposed rulemaking related to the proposed rule's scope, credit risk, operational risk, and market risk provisions. It also recommends limited adjustments to the rule regarding risk weights on some residential mortgages and clean energy investments.

**The proposal would incorporate lessons from the 2008 crisis about the failure of internal models to anticipate the severity of losses in trading and capital markets.** The largest institutions were woefully undercapitalized and overleveraged in 2008 substantially because they were over reliant on internal models that failed to estimate the severity of losses or estimate the amount of capital that would have been needed to prevent the 2008 bank failures.<sup>12</sup> Currently, banks can use their own data and mathematical modeling techniques to project estimated credit and risk losses (such as estimating the risk of their borrowers' default). These models can incorporate subjective assumptions that underestimate risks, and the individual models used by different banks can vary significantly. The Basel II Accord's internal models' approaches fell substantially short during the 2008 crisis. The 2013 Basel II changes nonetheless allowed the largest banking organizations to maintain their reliance on internal models that continued to dramatically underestimate some financial risks.

Under present rules each individual bank can select the data it uses to evaluate risk and set the parameters and model calibrations that assess the risks, and these models can vary significantly between banks even for identical risks (such as the same sized loan to the same borrower). Several studies have found widespread variations in the way lenders conduct assessments.<sup>13</sup> U.S. regulators have placed some limits on the use of these models (such as adding some controls on the use of allowable models), but as former FDIC chair Sheila Bair noted, the large banks are still relying on internal models that "understate their risks" and "allow them to lower their capital requirements to boost their returns."<sup>14</sup>

The Basel Committee has published an analysis illustrating the variability of credit-risk-weighted assets across banking organizations, based in significant part on the internal modeling choices that banks make (such as the length of data periods used). Using internal models allows banks to effectively lower their capital requirements by managing their internal model outputs to make their risk exposure seem lower, rather than through the actual reduction of RWAs. Banks can effectively manipulate the data inputs and their loss assumptions that can change the estimate of the underlying capital needs. The proposed regulation would appropriately address these known shortcomings by eliminating the firms' reliance on the internal risk models unfit for use based on lessons from past crises, or (in the case of market risk) by substantially reducing the reliance on internal models. Instead, the proposed rule would require banks to transition to improved standardized models, with a narrow exception for some market risk models authorized by supervisors, to improve the transparency and consistency of measurement of these risks.

The proposed rule appropriately applies these improved model requirements across a range of risks that would bolster capital levels, improve safety and soundness, and enhance financial stability. It would introduce these changes to the determination of capital for market risk, operational risk, credit risk, and derivatives-related credit CVA risk, raising capital levels the most for large trading books and banks with significant operational risk losses

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<sup>12</sup> Gruenberg, Martin J. Chairman. FDIC. "[Basel III Endgame at the Peterson Institute for International Economics.](#)" June 22, 2023.

<sup>13</sup> Bank for International Settlements. Basel Committee on Banking Supervision "Regulatory Consistency Assessment Program (RCAP) Analysis of Risk Weighted Assets for Credit Risk in the Banking Book." July 2013; BIS. BCBS. "Analysis of Risk-Weighted Assets for Credit Risk in the Banking Book." April 2016; Plosser, Matthew C. and João A. C. Santos. New York Federal Reserve Bank. "Bank's Incentives and Quality of Internal Risk Models." Staff Report No. 704. December 2014.

<sup>14</sup> Bair, Shiela. "[The truth about proposed bank capital rules, New measures are an important step to protect the U.S. and world economies against future financial crises.](#)" *Financial Times*. September 2, 2023.

in their history. The large capital rule would also expand the Basel III scope to include all banking firms over \$100 billion in total assets. This would restore relevant capital requirements for banking organizations in the same total assets band as the three banks that failed in March to May 2023.

**Reduced reliance on internal models would drive greater market risk charges for the largest banks most dependent on internal models.** In the lead-up to the 2008 financial crisis, the largest banks were over-reliant on their own overly-optimistic market risk models and were thus too undercapitalized to account for their real market risk, particularly for the severity of price declines and unprecedented volatility across multiple markets. Stock markets lost over 50 percent of their value from the October 2007 peak to the March 2009 trough.<sup>15</sup> The Risk-weighted capital measures vastly underestimated the economic turmoil among the largest banks in the 2008 financial crisis.<sup>16</sup> The Federal Reserve Bank of New York concluded that typical models did not predict the extreme outcomes necessary for the estimation and allocation of capital.<sup>17</sup> The proposed rule would improve risk-based capital for market risk by better accounting for stress losses and increasing the capital provision required for less liquid trading positions. The proposed rule would require banks to increase their capital levels to more fully prepare for market risks and better position the banks to weather market turbulence and potential steep losses in mark-to-market value of publicly traded securities in financial downturns. The proposal would also improve the standardized approach for credit risk by incorporating more credit risk drivers like, for example, borrower and loan characteristics, that differentiate between types of credit risk.

The proposal would materially increase large banks' capital, with the greatest impacts falling on the largest banks with big capital markets and trading operations.<sup>18</sup> The megabanks would appropriately be required to increase their capital levels, since these institutions were responsible for much of the market risk and operational risk loss during the 2008 crisis, especially those with large capital markets and trading operations. The agencies anticipate common equity tier 1 capital requirements would increase by an estimated 16 percent for large holding companies, including minimums and buffers. Bank holding companies subject to Category I or II capital standards would have the strongest capital requirements, with an estimated 19 percent increase; Category III and IV U.S. domiciled operations of foreign banking organizations would increase by about 14 percent; and Category III and IV domestic holding companies, by 6 percent.

**Banks with a history of operational risk losses would be subject to higher operational risk charges under the proposal's revised standardized approach to operational risk.** The improved standardized approach for operational risk includes accounting for prior losses associated with a bank's operational risk exposure. It is appropriate to require banks to hold capital for operational lapses that incurred institutional costs or losses and compromised their financial strength. "Operational risk exposures have been, and continue to be, a persistent and growing risk for financial institutions. For example, large financial institutions faced stiff settlement costs associated with their mortgage activities contributing on a large scale to the 2008 crisis, while in recent years

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<sup>15</sup> Dwyer, Gerald. Federal Reserve Bank of Atlanta. Center for Financial Innovation and Stability. "[Stock Prices in the Financial Crisis: Notes from the Vault.](#)" September 2009.

<sup>16</sup> Jordà, Òscar, Björn Richter, Moritz Schularick, Alan M. Taylor. Federal Reserve Bank of San Francisco. "[Bank Capital Redux: Solvency, Liquidity, and Crisis.](#)" June 2017.

<sup>17</sup> Senior Supervisors Group. "[Risk Management Lessons from the Global Banking Crisis of 2008.](#)" October 21, 2009.

<sup>18</sup> Notice of Proposed Rulemaking. "[Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity.](#)" Office of the Comptroller of the Currency, Treasury, the Board of Governors of the Federal Reserve System, and the FDIC. 88 Fed. Reg. 179. September 18, 2023 at 64169.

ransomware attacks, as well as other cybersecurity risks, have increased significantly,” noted FDIC Chair Martin Gruenberg.<sup>19</sup>

**The proposal would require banks to increase capital levels to account for derivatives-related credit valuation adjustment (CVA) risk<sup>20</sup> by improved or more consistent capture of the relevant risks.** Before the 2008 financial crisis, parties to a derivative contract never considered the other counterparties’ credit risk due to the generally high credit rating of counterparties and the relatively small size of derivative exposures. Derivatives parties implicitly believed that their counterparties could not default on their financial obligations like parties in other business lines. However, during the 2008 crisis, some financial institutions with highly leveraged derivatives positions faced steep declines in value (especially those tied to mortgage-backed securities like credit default swaps) that contributed to the collapse of dozens of financial institutions. As a result, market participants started incorporating CVA risk when calculating the value of over-the-counter derivative instruments.<sup>21</sup> The proposed rule would require banks to replace the current bespoke model approach for measuring capital requirements for CVA risk with more standardized, non-model approaches which would improve the risk sensitivity of CVA risk to losses on certain derivatives. Banks would need to maintain capital levels to more accurately reflect the risk that these derivative positions could pose to institutional safety and soundness. The proposal includes a less burdensome option intended for less complex banking organizations commensurate to their risk.

**The proposal would restore Basel III requirements for Category IV banking organizations.** The proposal would cover all institutions with total assets of \$100 billion or more and would remedy the weaknesses in current capital standards that have exempted Category IV institutions. In 2019, the banking agencies removed all Category IV firms from enhanced capital and other prudential standards — a more expansive deregulation than was required by the Economic Recovery, Relief and Consumer Protection Act. This exemption means that firms with assets between \$100 billion and \$250 billion in total assets are not currently required to maintain the initial Basel III capital standards, leaving banks of this size potentially undercapitalized for adverse financial conditions.

The 2023 failures of Silicon Valley Bank, First Republic, and Signature Bank demonstrated how quickly contagion can take hold and be propagated by and through this size class of banks. Further, a more robust capital cushion inspires the confidence of stakeholders and counterparties. News about SVB’s sale of assets at a substantial loss to meet its liquidity needs cratered depositor and investor confidence that precipitated additional liquidity run and spread contagion to other vulnerable firms in the same asset size band.<sup>22</sup>

**The proposal would include Category III and IV<sup>23</sup> banks’ unrealized securities losses (and gains) in regulatory capital.** The large bank proposal removes the existing opt-out clause for unrealized capital losses and gains for Category III and IV firms, aligning this aspect of the regulatory capital calculation across firms in all four size categories. Currently, Category III and Category IV banks can choose not to report unrealized losses or gains in

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<sup>19</sup> Gruenberg, Martin J. Chairman. FDIC. “[Basel III Endgame at the Peterson Institute for International Economics.](#)” June 22, 2023.

<sup>20</sup> The valuation change of over-the-counter (OTC) derivative contracts resulting from the risk of the counterparty’s defaulting prior to the expiration of the contracts, known as the credit valuation adjustment (CVA), depends on (1) counterparty credit spreads, which reflect the creditworthiness of the counterparty perceived by the market, and (2) credit exposure generated by CVA risk covered positions.

<sup>21</sup> CVA refers to adjustments to transaction valuation to reflect the counterparty’s credit quality. CVA is the fair value adjustment to reflect credit capacity rating (CCR) in valuation of derivatives. The valuation change of OTC derivative contracts resulting from the risk of the counterparty’s defaulting prior to the expiration of the contracts. Source:

<sup>22</sup> Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank. April 28, 2023. <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>.

<sup>23</sup> Board of Governors of the Federal Reserve System. [Tailoring Rule Visual.](#) October 10, 2019.

their calculation of regulatory capital. This opt-out clause has allowed banks to keep the impact of unrealized securities losses on capital less transparent to investors, other counterparties, and depositors. The losses have been particularly significant for bond and other longer-term holdings during the recent rising interest rate environment. SVB was highly vulnerable to interest rate risk, but the SVB board of directors, senior management, and Federal Reserve supervisors failed to act, according to the Fed's SVB report. This was, at least in part, because Category III and Category IV firms (like SVB) had the ability to opt-out of including securities losses in their accumulated other comprehensive income (AOCI) for calculating regulatory capital. As a result, SVB's regulatory capital appeared substantially more adequate than it really was, given the bank's large concentration of unrealized securities losses. This lack of transparency made it harder for supervisors, depositors, and investors to gain a full understanding of the impact the underwater securities portfolio would have on capital. SVB lacked the necessary capital reserves to sustain the losses when they were realized.

**AFREF supports the proposed rule's improvement to capital standards, but recommends the agencies rethink the proposed new risk weighting for residential mortgages, and instead retain existing risk weights so that they do not have adverse impacts on lower-income families, Black and Latinx families, and first time homebuyers.**

The subprime mortgage crisis was driven by aggressive sales of loans with abusive and unsustainable terms, not by low downpayments, and recent research has confirmed that it is income shocks, not lack of equity, that drives default. Furthermore, the risk of mortgage default has been substantially reduced by improvements in loss mitigation, including notably the widespread use of payment deferral loan modifications widely utilized during the COVID crisis. These loan modifications and other measures prevented a drastic spike in defaults during the depths of the crisis and have contributed to the historically low mortgage default rates we are experiencing now. Lower downpayments are also particularly important at a time when most borrowers cannot make a 20 percent down payment of nearly \$80,000 for the typical home purchase.<sup>24</sup> AFREF urges the agencies not to raise risk weights for these loans in the manner proposed; maintaining lower risk weights would appropriately reflect credit risks, not undermine the broader capital proposal, and avoid damage to macroeconomic policy objectives on affordable housing and equitable homeownership.

**Stronger capital standards are necessary to protect people from financial crises that harm individuals, households, and communities across the country and have a disproportionately devastating impact on Black, Latinx, and lower-income people and communities.** The bank capital proposals are critical to improving the industry's resilience to stresses and shocks that, in the worst cases, lead to bank failures that can reverberate across the U.S. economy. The 2008 financial crisis robbed millions of Americans of their wealth and homeownership, with particularly devastating impacts on people and communities of color.<sup>25</sup> The large bank failures and financial sector free-fall during and after the 2008 crisis set back the U.S. economy for years, evaporating retirement and household savings for millions of families. A 2020 study by Stanford and UCLA economists that looked at recessionary periods over the past 150 years found that "recessions in the aftermath of financial crises are severe and protracted" and "longer and deeper than the recessions surrounding non-financial crises."<sup>26</sup> Many families — especially Black and Latinx families — barely began to make up for lost ground when the pandemic overturned their economic lives again.<sup>27</sup>

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<sup>24</sup> National Association of Realtors. Economic Outlook October 2023. 2023.

<sup>25</sup> Bayer, Patrick, Fernando Ferreira, and Stephen L. Ross. "[What Drives Racial and ethnic Differences in High-Cost Mortgages? The Role of High-Risk Lenders.](#)" *Review of Financial Studies*. Vol. 31, Iss. 1. January 2018 at 175 to 205.

<sup>26</sup> Krishnamurthy, Arvind and Tyler Muir. National Bureau of Economic Research. "[How Credit Cycles across a Financial Crises.](#)" Working Paper No. 23850. September 2020.

<sup>27</sup> Adejumo, Vincent. "[African Americans' economic setbacks from the Great Recession are ongoing — and could be repeated.](#)" *The Conversation*. February 5, 2019.

The banking and financial system's woefully inadequate capital levels were incapable of cushioning the mounting losses that flowed from the promotion of predatory lending pumping up the real estate asset bubble. The financial crisis destroyed the homeownership equity of millions of families and losses were especially pronounced for Black and Latinx families. Low- and moderate-income people disproportionately lost savings, homes and home equity to predatory lending and the subsequent tsunami of foreclosures. Younger and middle-aged Black and Latinx families were especially hard-hit by a wave of foreclosures from push-marketed subprime loans and declining home prices that reduced or wiped out many owners' home equity that comprised a large part of their net worth before the crash.<sup>28</sup> The real median home equity for Black and Latinx homeowners fell about twice as fast as it did for white homeowners from 2007 to 2016 (falling by 28 percent for Black homeowners, 24 percent for Latinx homeowners, and 14 percent for white homeowners).<sup>29</sup>

Communities of color also felt the brunt of job and income losses during the recession stemming from the crisis, with unemployment and poverty rates rising faster and falling slower for Black and Latinx families than for white families. The Bureau of Labor Statistics reported that the peak Black unemployment rate in the wake of the financial crisis was 82 percent higher than the peak white unemployment rate and the peak Latinx unemployment rate was 41 percent higher.<sup>30</sup> An Urban Institute paper found that the combination of unemployment, foreclosure, and the erosion of home equity eliminated nearly half the wealth of Black and Latinx families (48 percent and 44 percent, respectively), compared to one-fourth of the wealth of white families (26 percent).<sup>31</sup>

**The proposed rules strengthen capital, making banks *more* able to provide necessary credit:** The proposed rules strengthen bank capital requirements to make the financial system more secure and resilient, which promotes the ability of banks to perform their critical economic functions like providing credit. Robust capital levels are the cornerstone of a resilient banking system that can better serve the U.S. economy. Well-capitalized and secure banks are essential to providing credit to businesses, families, and communities because they can absorb losses to enable them to continue to provide critical banking services throughout the business cycles, including during times of stress. Inadequately capitalized banks can and do fail in times of economic stress and the customers of those failed institutions — businesses and families — lose their access to credit *because* their banks were undercapitalized. More well capitalized banks are more able to provide credit to customers and communities, contrary to the industry's contention that increased capital requirements would undermine credit availability. A 2020 World Bank report summarized several studies that found that well-capitalized banks in the United States had higher loan growth than nearby banks with fewer capital reserves, that well-capitalized large U.S. banks had higher loan originations and liquidity, and that better-capitalized international banks had lower funding costs that enabled them to increase lending.<sup>32</sup>

**The proposal appropriately conforms to international regulatory consensus in a U.S. regulatory and financial landscape.** The Large Bank Capital proposal is intended to align the U.S. with the standards adopted by the Basel Committee on Banking Supervision (BCBS). A global financial regulatory floor should be a central policy objective of the United States. The United States has a strong incentive to participate in BCBS and other global standard-

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<sup>28</sup> Emmons, William R. and Bryan J. Noeth. Federal Reserve Bank of St. Louis. "[Household Financial Stability: Who Suffered the Most from the Crisis?](#)" July 1, 2012.

<sup>29</sup> Americans for Financial Reform Education Fund calculation from Federal Reserve Board Survey of Consumer Finances data.

<sup>30</sup> Cunningham, Evan. Bureau of Labor Statistics. "[Great Recession, great recovery? Trends from the Current Population Survey.](#)" *Monthly Labor Review*. April 2018.

<sup>31</sup> McKernan, Signe-Mary et al. Urban Institute. "[Impact of the Great Recession and Beyond: Disparities in Wealth Building by Generation and Race.](#)" April 2014.

<sup>32</sup> World Bank, Global Financial Development Report, 2019/2020, Chapter 3 [Bank Capital Regulation](#) at 85.



setting bodies because members typically limit foreign operations to firms based in countries that are Basel-compliant, and the largest number of highly-interconnected as well as globally systemically important banks (GSIBs) are headquartered in the United States.<sup>33</sup>

The U.S. participation in the Basel accords has made real progress towards this goal. However, the measure of effectiveness should not be whether the United States managed to meet the global minimum standard. A robust regulatory system should ensure that the financial system contributes to sustained, equitable growth in our real economy, and it is reasonable for U.S. regulators to apply stronger safeguards where appropriate.

## **I. The scope, application, and approach of proposed rules provides necessary capital improvement**

***Capital and other safety and soundness regulations, existing and proposed, are designed to work in combination with each other to strengthen firms' safety and soundness and financial resiliency (Question 1)***

AFREF supports the proposed rule's approach that is integrated with other pending safety and soundness and resolution proposals. The recent proposed long-term debt,<sup>34</sup> resolution planning,<sup>35</sup> and the parallel GSIB surcharge proposal<sup>36</sup> would together strengthen large banks' safety and soundness as going concerns and in resolution, and would increase financial system resiliency. The long-term debt proposal would dimension a long-term debt requirement based on required regulatory capital ratios, including risk-based and leverage-based capital. The resolution plan proposals would complement the long-term debt and capital proposals by strengthening guardrails for when a large bank failure is unavoidable and mitigate the financial impacts on other firms, banking clients, the broader financial system, and the public. AFREF supports these rulemakings and the ways each of them contributes to safety and soundness and financial resiliency objectives. However, none of the other recently proposed or existing rules, individually or in combination, should distract from, or be considered a substitute for stronger equity capital requirements.

AFREF supports how the large bank capital rule would impact the existing Single Counterparty Credit Limit rule, introduced in Section 165e of the Dodd Frank Act and implemented with the 2013 Basel III enhanced prudential standards. The single counterparty credit limit is a critical control that limits the amount of exposure one large banking organization can maintain to a single counterparty.<sup>37</sup> The large bank capital proposal appropriately would make the single counterparty credit limit more stringent by increasing the amount of exposure captured in the limit for any given client, based on the revised counterparty credit risk standardized approach (CCR-SA).

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<sup>33</sup> Bank for International Settlements. "[Global systemically important banks: Assessment methodology and the additional loss absorbency requirement.](#)" November 2011; Financial Stability Board. "[2022 List of Global Systemically Important Banks \(G-SIBs\).](#)" November 2022.

<sup>34</sup> Office of the Comptroller of the Currency, Federal Reserve System, and the Federal Deposit Insurance Corporation. 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. 180. September 19, 2023. 64524 et seq.

<sup>35</sup> These proposals include: 1) FDIC Resolution Plans Required for Insured Depository Institutions With \$100 Billion or More in Total Assets; Informational Filings Required for Insured Depository Institutions With at Least \$50 Billion But Less Than \$100 Billion in Total Assets (FDIC-2023-0060-0001); 2) Guidance for Resolution Plan Submissions of Domestic Triennial Full Filers; and 3) Guidance for Resolution Plan Submissions of Foreign Triennial Full Filers.

<sup>36</sup> Federal Reserve. "Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)." 88 Fed. Reg. 169. September 1, 2023. at 60385 et seq.

<sup>37</sup> The Basel related single counterparty credit limit (SCCL), grounded in Section 165e of the Dodd Frank Act and implemented in the U.S. together with the Enhanced Prudential Standards and Basel III rulemaking in 2013, to limit the amount of exposure of one large banking organization to a single counterparty.

The single counterparty credit limit constrains the size of one firm's exposure to a single client and limits the respective large firms' exposure to each other, both important elements for a resilient financial system. As noted in the proposal, the proposed elimination of the internal model method for calculating derivatives exposures would require all large banking organizations to use the standardized approach for counterparty credit risk to calculate their single counterparty credit limits. The agencies estimate that the standardized approach for counterparty credit risk would result in recognizing higher derivative exposures than the internal model method and thus warrant higher capital levels. Therefore, credit limits for counterparties to which a banking organization has derivatives exposure would appropriately become more stringent under the proposal.<sup>38</sup>

***The proposal's scope expansion to include all banking organizations in the Fed's tailored supervision framework strengthens capital protections for banks in the total assets range of the failed banks in 2023, benefiting individual and business clients, investors, and the public (Questions 2 and 4)***

The proposal importantly would expand the enhanced capital standards framework to banks with total assets of greater than \$100 billion to incorporate lessons from the 2023 crisis when undercapitalized Category III and IV firms failed. This provision is essential to restore the capital standards that were rolled back in 2019 to enhance financial system stability and benefit depositors, investors, and communities who rely on reasonably priced access to banking services.

The cost and operational burden are appropriate to achieve the necessary capital levels that are commensurate to the size and complexity of these institutions. AFREF believes materiality thresholds for any elements of the proposed rule are not necessary for these institutions because of the reduced complexity of the revised standardized approach. The proposed revised standardized approach also requires fewer resources - including people, systems, processes, and controls - for model development and model governance.

The proposal would also importantly restore the countercyclical capital buffer and supplementary leverage ratio for category IV firms. These ratios provide an important non-risk-adjusted check against some concentrations of outsized risk that may otherwise go unchecked with exclusively risk-based capital requirements.

***The proposal would harmonize regulatory capital across large banking organizations and jurisdictions, creating more consistent and comparable levels of capital for similar risk exposures (Question 3)***

The proposed rule would require more standardized risk models that would make it possible to more directly and accurately compare the risk exposure within and between institutions. The agencies need to be able to compare risk profiles and capital outcomes across banks and over time to maintain consistent capital requirements across banks.<sup>39</sup> Currently, since each bank uses its own individual risk model, there can be considerable variation in the different firms' assessment of its risk-weighted assets. According to the Basel Committee, the Basel III capital improvements will "reduce excessive variability of risk-weighted assets" that will enhance the "robustness and risk sensitivity of the standardized approaches for credit risk and operational risk, which will facilitate the comparability of banks' capital ratios."<sup>40</sup>

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<sup>38</sup> Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity 88 Fed. Reg. 179. 64171.

<sup>39</sup> Bank for International Settlements. Basel Committee on Banking Supervision. "[The regulatory framework: Balancing risk sensitivity, simplicity and comparability.](#)" Discussion paper. July 2013.

<sup>40</sup> Basel Committee on Banking Supervision. "[Basel III: Finalising post-crisis reforms.](#)" December 2017.

The proposed rule requires banks to adopt the more conservative of two methods of calculating risk-weighted assets — an expanded risk-based approach or the standardized approach. Banks would be required to make both calculations and would have to maintain the more conservative capital requirement for the calculation of the risk capital buffer. This provides for a Standardized Output Floor so that the continued use of internal models for market risk does not result in unwarranted reductions in capital requirements, as elaborated in response to question 5 below.

***The proposal would maintain two methodologies to determine risk-based requirements no lower than those applicable to smaller, less complex banking organizations (Questions 5 and 6)***

The proposal would prudently maintain a dual-methodology structure that requires large banking organizations to calculate risk-weighted asset amounts under the current standardized approach and the expanded, risk-based approach and use the higher of the two risk-weighted asset amounts to satisfy minimum capital requirements. This approach would assign capital requirements applicable to large banking organizations that are at least as strict as those applicable to smaller banking organizations.

The proposal requires banks to use the revised standardized approach for market risk, but in narrow circumstances allows for the continued application of internal models for market risk. This allows some flexibility to use internal models in selected instances when the market and the product set are well controlled and the internal risk models have a track record of effective model governance. The proposal introduces market risk controls, most notably more granular, trading desk level backtesting and profit and loss attribution processes that would mitigate against any unintended consequences, such as the banks abusing the limited internal models that are permitted in the proposal. Although banks are permitted to use these specific and approved internal market risk models, the proposed rule also includes a risk “output floor” that would establish minimum capital floor requirements even under the internal model.

***The proposal would prudently require company-run stress tests and stress capital buffers to be based on the more stringent risk-weighted asset calculation (Questions 7 and 9)***

The proposed rule strengthens the existing requirements for stress buffers (the additional capital to withstand economic or financial crisis) and stress-testing to more accurately capture risk and to adopt capital requirements from the more stringent of the risk-weighted asset calculations. The stress test and the related stress capital buffer requirement helps a banking organization withstand losses from a severely adverse scenario. The agencies would appropriately revise the calculation to more conservatively capture risk and forecast losses under their stress tests, among other changes. A key revision would require the calculation to be based on the higher capital requirement of the two approaches, the existing standardized approach versus the proposed expanded risk-based approach, for a given firm.

This approach would allow the more severe stresses in an expanded risk-based stress capital buffer to prevail and thus would result in a more robust capital cushion that could withstand greater market shocks. The proposed calculation methodology would also serve as a check against uncapitalized excessive risk taking by adding risk sensitivity to the stressed capital buffer requirements and providing the public with information about the banks' risks and resilience. As Vice Chair Barr noted in December 2022:

The stress test can achieve a higher degree of risk sensitivity than the standard Basel risk weights. The stress test can also be more dynamic than the capital rules because a new test is conducted each year, reflecting a new set of hypothetical financial and economic conditions and updates to the banks' risk profile. Lastly, the stress test can potentially counteract actions by a bank to 'optimize' against the capital

regime — for instance, lowering its risk-weighted assets without reducing its risk. In this way, the stress test — along with strong supervision — can serve as a check on excessive bank risk-taking.<sup>41</sup>

AFREF does not believe there should be a transition period for the revised approach to the stress capital buffer above and beyond the conformance period for the final rule to take full effect.

***Agencies and FASB must address ‘available for sale’ and ‘hold to maturity’ financial accounting policy shortcomings that allow the industry to avoid proper financial accounting for held-to-maturity assets (Question 10)***

The proposal seeks to remove the accounting loophole that enabled SVB and other similarly-sized banks to report regulatory capital numbers that made their capital positions appear stronger than they were. Financial accounting gimmicks that allowed banks to obscure losses on some assets can contribute to bank undercapitalization and contributed to the 2023 bank failures. Unrealized losses on available-for-sale (AFS) and held-to-maturity (HTM) securities were a key factor in SVB’s collapse. The capital proposal would end the exemption that permits some banks to conceal losses on securities they hold and instead require banks to provide full transparency related to unrealized gains and losses on securities in mid-sized Category III and IV banks’ risk reporting to senior management, boards of directors, and in the firm’s public disclosures.

## **II. The proposed rule would have large banking organizations hold enough capital to absorb losses from severe credit deterioration and credit losses**

The proposed rule would appropriately remove internal modeling from firms’ loss estimation and from the determination of how much credit risk capital banks should hold. The industry’s overblown claims about the proposal’s negative impacts to credit availability for businesses and individuals are deceptive and disingenuous. The proposed rule would assign higher risk weights to the *riskiest* banking practices relative to the more standard and lower-risk lending.

The proposed rule would require a revised standardized approach that reduces variability across firms and is designed to be more sensitive to different gradations of credit risk. The proposal would achieve this with the introduction of gradations of risk, including some traditional credit measures such as loan-to-value. This approach considers other process or control factors that might differentiate the risk of one exposure from another for a particular product set. AFREF also recommends that the agencies refine their approach to higher loan-to-value residential mortgages and consider targeted adjustments to the climate-related tax equity financings, as discussed further below.

Many studies have found that increased capital requirements actually *promote* lending. Requiring more capital in banks’ funding structure would not materially increase the cost of making loans, contrary to industry claims, as described by Professors Steven Checchetti and Kim Schoenholtz:

The primary debate is over regulators’ call to raise capital requirements — that is, increase the fraction of banks’ funding that comes from shareholders (equity) rather than from depositors or bondholders (borrowing). Bank advocates argue that this equity is somehow idle, so any increase in required capital wastes resources and depresses lending, reducing the ability of households and businesses to finance essential activities.... This is wrong. The truth is that capital is never a wasted resource. It is a source

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<sup>41</sup> *Ibid.*

of funds that the bank uses to provide loans. A well-capitalized bank has more resources to supply credit, not fewer.<sup>42</sup>

Well-capitalized banks have a lower probability of default which lowers their funding costs compared to their peers, as the Bank of International Settlements (BIS) noted in a 2016 study.<sup>43</sup> A 2019 Stanford University paper found that higher capital requirements would “reduce banks’ funding costs and thus increase bank lending.”<sup>44</sup> The cost of credit is unlikely to significantly increase as a result of higher capital standards. A 2010 University of Chicago-Harvard University paper estimated that even much higher increases in capital requirements — by 10 percentage points, far in excess of the estimated 3 percentage point increases under the proposed rule — would only increase loan rates by less than 50 basis points (25 to 45), meaning the proposed rule would have negligible or minimal impacts on the cost of loans.<sup>45</sup>

More robust capital requirements bolster financial resiliency and reduce the likelihood of financial crises, which enhances banks’ ability to maintain credit availability throughout the booms and busts of economic cycles. Higher bank capital also allows banks to lend more during a downturn and can lead to a quicker economic recovery. In 2020, World Bank researchers found that bank “capital can help banks smooth the supply of credit during crisis years. In times of economic turmoil, banks with larger capital buffers are somewhat protected from cuts in lending.”<sup>46</sup> A 2019 St. Louis Federal Reserve Bank study found that stronger capital levels reduced the likelihood and improved the response to financial crises that could forestall credit crunches, and “in all cases the economic benefits of moderate increases to in capital levels above current levels exceed the economic costs.”<sup>47</sup>

Countries with better capitalized banking systems in 2006, prior to the start of the financial crisis, experienced higher lending growth both during and after the crisis, as noted by economics professors Stephen Cecchetti and Kermit Schoenholtz.<sup>48</sup> A 2022 Bank for International Settlements study found that, after the Basel III reforms, aggregate bank lending grew for banks above the initial median regulatory capital ratio and but fell for banks below the initial median regulatory capital ratio.<sup>49</sup>

Furthermore, if there is an extreme level of capital requirements that would impair lending activity and hamper economic growth, the capital levels in the U.S. banking system — and the capital levels required by the proposal under discussion here — fall well under that threshold, and under what most academics, regulators, and other independent experts suggest is an optimal level.

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<sup>42</sup> Cecchetti, Steven and Kim Schoenholtz. “[Ignore the bank lobby, regulators. It’s high time for banking reform.](#)” *Washington Post*. January 10, 2024

<sup>43</sup> Gambacorta, Leonardo and Hyun Song Shin. Bank for International Settlements. “[Why bank capital matters for monetary policy.](#)” BIS Working Paper No. 558. April 7, 2016.

<sup>44</sup> Begenau, Juliane. Stanford Graduate School of Business. “Capital Requirements, Risk Choice, and Liquidity Provision in a Business-Cycle Model.” January 14, 2019.

<sup>45</sup> Kashyap, Anil K., Jeremy C. Stein, and Samuel Hanson. University of Chicago and Harvard University. “[An Analysis of the Impact of ‘Substantially Heightened’ Capital Requirements on Large Financial Institutions.](#)” May 2010.

<sup>46</sup> World Bank, Global Financial Development Report, 2019/2020, Chapter 3 [Bank Capital Regulation](#) at 85.

<sup>47</sup> Firestone, Simon, Amy Lorenc, and Ben Ranish. St. Louis Federal Reserve Bank. “An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the United States.” *Federal Reserve Bank of St. Louis Review*. Third Quarter 2019.

<sup>48</sup> Cecchetti, Stephen and Kermit Schoenholtz. “[Higher capital requirements didn’t slow the economy.](#)” *moneyandbanking.com*. December 15, 2014.

<sup>49</sup> Bank for International Settlements, Basel Committee on Bank Supervision. “[Evaluation of the impact and efficacy of the Basel III Reforms.](#)” December 14, 2022.

For example, professor James Barth and Mercatus Center Senior Fellow Stephen Matteo Miller estimated that the optimal capital to risk-weighted assets ratio, where benefits equal costs, is around 25 percent.<sup>50</sup> Similarly, the Minneapolis Fed, as part of their proposal to end the “too-big-to-fail” problem, calculated that the optimal level of capital to risk-weighted-assets to be 23.5 percent.<sup>51</sup> These levels are far above what the Kansas City Fed has found in its semi-annual review of bank capital levels. In December 2022 the weighted average Tier 1 risk-based capital ratio for GSIBs was 14 percent and 11 percent for non-GSIB banks with more than \$100 billion in assets. Using the same metric, community and regional banks are currently holding more capital than large banks, 13.4 percent and 12.2 percent, respectively.<sup>52</sup> The proposed rules would increase Tier 1 capital for GSIBs to an estimated 17 percent, for example.

***The proposal’s enhanced standardized approach to credit risk would appropriately remove internal models that proved so inadequate in the 2008 financial crisis (Questions 11 and 12)***

The proposal would replace the internal credit risk model approach with a revised standardized credit risk approach that differentiates between types and gradations of risk specified by product. In addition, the proposal introduces greater sensitivity to risk weights and updates the definitions and provisions for due diligence, defaulted exposure, and retail bankruptcy. For example, the revised framework would introduce three risk buckets and associated risk weights for lending to banking organizations. The first one would be reserved for banking organizations that are well capitalized and have no constraints on payouts to shareholders. The second risk bucket would be reserved for banking organizations whose regulatory capital ratios qualify for well capitalized but have constraints on payouts to shareholders. The third bucket would be for other banks that don’t meet the qualifications of the first two buckets. The proposal would also refresh the definition of credit risk-weighted assets by prohibiting internal credit risk models and incorporating the Dodd-Frank prohibition against the use of rating agency ratings. AFREF supports these changes.

AFREF believes the proposal should include a robust due diligence requirement for credit transactions defined as regulated. Due diligence is the most fundamental of controls for making sure the risks in a transaction are understood by both sides. The proposal should codify a due diligence requirement into the risk weights for regulated transactions to include review and disclosure of any banker conflicts of interest as well as all the material risks concerning the obligor, the structure of the transaction, the market, and its regulatory requirements. The agencies should specify that appropriately steep increases in risk weights would be required if due diligence requirements are not met.

***The proposal should require large banking organizations to identify obligor borrowings from other lenders, including those that meet the defaulted exposure definition, without undermining obligor protections (Questions 14 and 15)***

Lenders to a range of client types often lack a full picture of a clients’ other borrowings when the clients’ credit worthiness deteriorates. The now-collapsed and indicted Archegos Capital Management was the poster child of a wealthy individual using their family office reputation and relationships with multiple megabanks to extract beneficial financing terms that enabled the obligor to increase leverage without being forthcoming about its other

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<sup>50</sup> Barth, James, Stephen Miller. [“Benefits and Costs of a Higher Bank Leverage Ratio.”](#) *Journal of Financial Stability*. February 2017.

<sup>51</sup> Fed Reserve Bank of Minneapolis. “The Minneapolis Plan to End Too Big to Fail.” January 2017.

<sup>52</sup> Pellerin, Sabrina. Federal Reserve Bank of Kansas City. [“Bank Capital Analysis Semiannual Update.”](#) As of December 31, 2022.

borrowing relationships.<sup>53</sup> In the Archegos instance, each prime broker lending to the family office unwittingly supported outsized concentrations, leverage, risky strategies, and ultimately fraudulent trades, without pricing-in the risks and without knowing the extent of the obligor’s relationships with peer banks that similarly allowed risky trades with Archegos to mount because of its preferred client relationships.

The proposal should include robust requirements to direct the firms to overcome these obstacles. Understanding a client’s broader banking relationships is important to the safety and soundness of the banks and the financial system for the purposes of managing the credit risk of customers as healthy borrowers and in bankruptcy.

**The proposal would introduce an improved approach to real estate (both residential and commercial) and selected other products, to differentiate between regulated and non-regulated credit assets and other creditworthiness differentiators (Question 23 to 33)**

The proposed rule creates improved risk gradations for different types of credit products, including real estate, that would generally improve the assessment of credit risk for loan portfolios. It relies on current definitions of what is investment grade and what is speculative grade but incorporates greater gradations of risk across the range of credit products. The proposal introduces a dividing line between “regulated” and non-regulated lending exposures, for example those applicable to residential and commercial real estate and introduces other gradations of risk. The regulatory residential real estate transactions would be defined as 1<sup>st</sup> lien, owner-occupied or rented, and not dependent on cash flows from the real estate. Dependency on cash flows is a defining attribute of a higher risk bucket in the case of residential and commercial real estate.

AFREF supports the overall approach, including the proposed gradations of risk for the different types of credit exposure. However, as discussed below, the proposal needs refinement for the residential mortgage risk weight. AFREF also supports differentiating levels of credit risk among other credit assets, by establishing regulated and non-regulated as risk criteria.

***The regulators should not proceed with the higher risk weights for higher loan-to-value residential mortgages in the proposal. (Question 23 to 33)***

The agencies should rethink the imposition of higher mortgage risk weights for higher loan-to-value residential mortgages envisioned in the proposed rule. The proposal notes that the agencies are supportive of homeownership and do not intend the proposal to have a disparate impact on home affordability or homeownership opportunities, including for lower- and medium-income, Black, Latinx, and other historically underserved borrowers. The proposal also notes that the agencies are interested in whether the proposed framework should be modified in any way to avoid unintended impacts on the ability of otherwise creditworthy borrowers who may make a smaller home purchase down payment. We urge the regulators to modify this element of the proposal.

The subprime mortgage crisis was driven more by the accretion of the push-marketed subprime mortgages with often toxic terms (exploding payments, high interest rates, negative amortization, and other so-called exotic terms) than by higher loan-to-value ratios. Today many homebuyers — especially first time buyers, lower-income households, and Black and Latinx families — cannot afford to make more than 20 percent down payments and will have LTV’s over 80 percent, but that does not automatically make these loans riskier. Not increasing risk

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<sup>53</sup> U.S. Department of Justice. [Press release]. [“Four charged in connection with multibillion-dollar collapse of Archegos Capital Management.”](#) April 27, 2022.

weights for these loans is consistent with attention to risk and will not undermine the proposal's stronger capital standards overall.

While we urge the agencies to make this change — because it is vitally important to not increase barriers to equitable homeownership — we also want to point out that the banking industry has tried to weaponize concerns about mortgage risk weights as a way to undermine the capital proposal overall, and they have told a partial and skewed story. Their public discussion of the issue has failed to note the limited reach of changes to mortgage risk weights in the proposal. There is no proposal to apply higher risk weights to either government-backed mortgages (through FHA or the Veterans Administration) or those securitized by the government-sponsored entities (GSEs) Fannie Mae or Freddie Mac. Currently, about 70 percent of the mortgage market is supported by Fannie and Freddie, and the vast majority of home mortgage loans to Black, Latinx, and lower-income borrowers are either government-backed or securitized by the GSEs. Also, only about 30 banks would be affected by the proposed rule and only a handful of those banks are significant players in the mortgage market. Non-bank lenders accounted for nearly 70 percent of mortgage originations in 2021 and over 60 percent in 2022.<sup>54</sup> Further, nonbank lenders are currently making more loans to Black and Latinx families than the big banks (although they are in many cases charging higher fees). Rocket, now the biggest originator in the United States, issued 12,029 mortgages to Black homebuyers in 2021, more than Wells Fargo, JPMorgan Chase, and Bank of America combined. These three banks together account for only 3 percent of home loans originated for Black borrowers, and this has been the case for the last five years.<sup>55</sup>

There is also some irony to the fact that the trade association of many of the big banks amplifying equitable lending concerns in this context is litigating to prevent the Consumer Financial Protection Bureau from treating lending discrimination as an unfair, deceptive, or abusive practice.<sup>56</sup> Unfortunately this is consistent with a long history of lending discrimination and disparate treatment of Black and Latinx borrowers that has substantially contributed to the racial wealth gap and the homeownership gap.

Again, these are not arguments to retain the proposal's approach on mortgages; we urge the agencies to keep mortgage risk weights for higher loan-to-value loans at their current levels. We also urge the agencies to approach with skepticism the big bank messages that treat concerns about the proposed mortgage risk weights as concerns about other key aspects of the rule. Regulators should also consider additional strategies to achieve well-capitalized banks that provide fair, equitable, and sustainable access to homeownership.

***The proposal's retail credit risk weights would appropriately include exposure to some small businesses and differentiate between types of retail lending (Questions 34)***

The proposal appropriately would increase the risk sensitivity of the capital requirements applicable to retail exposures by assigning risk weights that vary depending on the product type and the degree of portfolio diversification. The proposal would assign more accurate and appropriate risk weights to riskier retail corporate

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<sup>54</sup> Choi, Ann et al. "[Borrowers turned to nonbank lenders for mortgages — and it's costing them.](#)" *Bloomberg*. December 18, 2023.

<sup>55</sup> Donnan, Shawn, Ann Choi and Christopher Cannon. "[Big US Banks Fall Short on Promises to Create Black Homeowners.](#)" *Bloomberg*. December 19, 2022. In Oct 2020, JPMorgan pledged to create 40,000 new Black and Latino homeowners on top of what it was doing in 2019. Instead, in 2021 JPM underwrote 122 additional mortgages for Black homebuyers, with the number of loans to Hispanic buyers actually falling. These abysmal results are even worse considering it was during the period of massive support by the Fed to the banks as a result of Covid-19.

<sup>56</sup> Flitter, Emily. "[Banks accuse consumer regulator of abuse of power.](#)" *New York Times*. September 28, 2022.



lending, but maintain the lowest risk weight to small business loans (loans under \$1 million to firms with less than \$50 million in revenues).

Strengthening capital requirements should shore up small business lending and even out the sharp small business lending contractions that occur following financial crises. The proposed rule should not curb small business lending (or lending in general, as described above). Several studies have found that higher capital requirements do not reduce small business lending. In 2019, the Financial Stability Board found that Basel III rules had not hurt lending to small- and medium-sized enterprises in the Basel Committee jurisdictions. The study found that the post-crisis capital and liquidity reforms had no meaningful or lasting negative impacts on small business lending. The valuation also provided some evidence for a reallocation of bank lending towards more creditworthy firms after the introduction of reforms, but this effect is not specific to SMEs.<sup>57</sup> The evaluation found no material and persistent negative effects on SME financing in general. According to a study by Moody Analytics, what impacts small businesses adversely is often poor due diligence and underwriting processes at banks.<sup>58</sup> Moreover, small businesses are deeply impacted by financial crises and more robust capital requirements should make these crises less frequent and less economically devastating.

Assigned risk weights would vary under the proposal depending on product type and the degree of portfolio diversification. These are two primary indicators of credit risk in retail portfolios historically. Credit performance has differed substantially across consumer products (e.g. student loans versus credit cards). As with real estate, the proposal would differentiate between lending products that qualify as eligible regulatory retail exposure (including small business loans) and those that do not. Eligible products include revolving credit, lines of credit, term loans, and leases, the most common credit products small businesses need to access.

***The proposal should allow for application of a lower risk weight than 100 percent to exposures of companies that are not publicly traded, but are “highly regulated,” such as pension funds or registered investment companies (Question 39)***

The proposal allows for lower capital charges for credit risk if the counterparty is a publicly traded investment grade company, but public pension funds that are typically low risk, highly regulated, and transparent understandably want the risk weights applicable to them to be commensurate with other entities posing similar low risk. As reflected in question 39, the agencies should entertain lower risk weights for certain non-publicly traded companies that are highly regulated such as public pension funds. These weights should be reflective of the typically low risk profile of these entities. However, the agencies should only pursue more sensitive risk weights for lower risk, highly regulated borrowers of this kind in a tailored manner. Any agency change to increase the sensitivity to allow for lower risk weights should be defined narrowly to avoid establishing a loophole for riskier entities than would be appropriate for the risk weight.

***Proposal would increase risk sensitivity to different types and structures of private funds, appropriately requiring more capital against exposure to asset management and investment advisor counterparties; agencies should undertake deeper analysis on ways to differentiate on risk that do not hurt clean energy tax equity investments (Question 71 to 73)***

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<sup>57</sup> Valladares, Mayra Rodriguez. Forbes. [“Newly Proposed U.S. Banking Rules Would Not Reduce Lending.”](#) September 22, 2023.

<sup>58</sup> Arun, Avinash and Helene Page. Moody’s Analytics. [“The future of small business lending.”](#) Moody’s Analytics Risk Perspectives. Vol. VIII. November 2016.

We appreciate that the proposed rule seeks to introduce greater risk sensitivity to the relevant risk weights. We believe clean energy investment is critically important to addressing climate-related financial risk. In the case of clean energy tax equity finance (TEF) exposures, we believe the agencies should revisit the proposal to set a final risk weight commensurate with the actual risk of these exposures.

Some commentators have recommended that the proposed risk weight for clean energy TEFs should be lowered from 400 percent to 100 percent.<sup>59</sup> We agree that the proposed 400 percent risk weight—consistent with the treatment for private equity exposures—might not be the correct weight for clean energy TEFs because the projects receive substantial tax benefits which might lower their risks. However, a 100 percent risk weight would clearly not be appropriate based on analysis of the relative risks of these exposures compared to others in the proposal.

For tax-credit eligible clean energy projects, TEFs are a high cost and complex financing option that generate a higher return for the bank compared to debt financing, and thus leave less overall revenue for the project itself.<sup>60</sup> This necessarily creates higher risk for the project whose continued operation is necessary to generate the tax credits which form the basis for most of the repayment to the bank. Because loans for clean energy projects are lower cost and lower risk than a TEF transaction, and because the proposal assigns a 130 percent risk weight to such loans during the pre-operational phase of a project, TEFs created to finance new clean energy projects should clearly have a risk weight higher than 130 percent. The proposal also sets the risk weight for subordinated debt exposures at 150 percent, and while banks in TEF deals receive senior equity and “projects typically do not allow senior debt that is secured by the project’s assets,”<sup>61</sup> any debt holders may take priority in the event of bankruptcy. The structure and norms of these financial arrangements are likely to be in flux in coming years due to new flexibility allowed by the Inflation Reduction Act (IRA),<sup>62</sup> as discussed below.

For further refinement of the risk weight, we suggest the agencies review the results of their enhanced supervision of banks with high levels of these exposures. The OCC codified the authority of national banks and federal savings associations to treat a limited amount of tax equity finance as loan-like for capital purposes (generally up to 5 percent of their capital and surplus) in 2020, but they specifically required substantial enhanced prudential monitoring and approval for higher levels of concentration, in recognition of the potential risks. They wrote, upon raising the limit (established in previous OCC interpretations) from 3 percent to 5 percent: “The OCC believes that a limit [on TEF transactions] is necessary but that the limit can be safely increased to five percent. Although TEF transactions will be subject to the legal lending limits on loans to one borrower...the OCC believes maintaining the aggregate transaction limitation will allow the OCC to assess how the authority is implemented and any safety and soundness concerns that may arise.”<sup>63</sup> If the OCC has since developed a better understanding of potential safety and soundness concerns, that should inform the setting of these risk weights.

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<sup>59</sup> Representative Casten, Sean, et al. U.S. House of Representatives. [Letter to Chair of the Federal Reserve Board, Chairman of the FDIC, and Acting Comptroller of the Currency](#). December 18, 2023.

<sup>60</sup> Heightley, Mark P., Donald J Marples, and Molly F. Sherlock. Congressional Research Service. “[Tax Equity Financing: An Introduction and Policy Considerations](#).” CRS Report No. R45693. April 17, 2019.

<sup>61</sup> Hunter, Lesley and Mason Vliet American Council on Renewable Energy. “[The Risk Profile of Renewable Energy Tax Equity Investments](#).” December 2023.

<sup>62</sup> Rubin, Richard. “[Big Companies on Verge of New Market for Clean-Energy Tax Credits](#).” *Wall Street Journal*. June 14, 2023.

<sup>63</sup> [85 Fed. Reg. 246](#). December 22, 2020 at 83698.

TEFs are not the only option for capturing the tax credit incentives expanded by the IRA, which allows annual transferability of the credits to third parties in exchange for cash.<sup>64</sup> TEFs became a prominent financing vehicle for tax credit-eligible clean energy projects by necessity when in the past developers or projects often lacked the tax liability needed to use the tax credits. The biggest banks quickly became the biggest players in the clean energy TEF sector, and they are currently extracting 15 cents for every dollar of clean energy tax credit dollar made available,<sup>65</sup> a high level of extraction that represents inefficiency in the spending of public resources and which may also worsen the economics of the underlying projects. Given the enhanced incentives and financing flexibility for clean energy projects created by the IRA, there is no reason that banks would be unable to profitably underwrite TEFs or loans for clean energy projects with capital standards more appropriately calibrated upwards. Moreover, developers' new ability to monetize the tax credits annually by selling to all types of corporations with tax liabilities may drastically expand the pool of capital providers for these projects.

Broadly, there must be a careful assessment of the risk for these various types of clean energy financing vehicles, and it must be accounted for fairly and fully within the capital framework for clean energy investment to be sustainable in the long term. It would be shortsighted to grant concessional capital status to TEFs that might inappropriately bias the market towards these products and lead to undercapitalization.

### **III. The proposed Rule establishes appropriate capital cushion for operational risk losses, especially for megabanks**

***The proposal would appropriately require large banking organizations with significant histories of violations to hold more capital for operational risk, including an internal loss multiplier, and importantly would incentivize the firms to reduce their outsized violations of laws, rules, and regulations (Questions 75 to 77 and 79)***

The proposed rule requires banking firms with a history of legal violations to set aside more capital to account for operational risk, which is a significant source of risk for U.S. banks. Banks lose millions of dollars every year from failing to identify, measure, control, or monitor operational risk exposures. From 2000 to August 2023, the twenty largest fines and settlements for bank operational risk failures due to process weaknesses and violations totaled \$325 billion.<sup>66</sup> Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems, or from external events. Operational risk includes legal risk but excludes strategic and reputational risk. Experience shows that operational risk is inherent in all banking products, activities, processes, and systems. Holding appropriate amounts of capital as a cushion against large scale losses associated with violations of laws, rules and regulations would incentivize banks to strengthen their internal controls to prevent violations of banking, consumer protection, and civil rights laws. Banks that obeyed the laws and regulations could avoid holding higher capital levels by improving their track record of violations over time.

The current Basel III operational risk approach not only allows, but *requires*, the largest banks to use internal models to estimate losses related to operational risk even though these models have proven to be highly inconsistent and have presented levels of uncertainty and volatility that are difficult to incorporate into the capital planning process. The banks' internal models do not require the megabanks to hold as much capital for operational risk as they should, based on lessons learned from the financial crisis of 2008. The proposed changes to operational

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<sup>64</sup> Rubin, Richard. "[Big Companies on Verge of New Market for Clean-Energy Tax Credits.](#)" *Wall Street Journal*. June 14, 2023.

<sup>65</sup> Jiang, Betty et al. Credit Suisse. "[US Inflation Reduction Act: A Tipping Point in Climate Action.](#)" September 28, 2022.

<sup>66</sup> AFREF calculation from Good Jobs First Violation Tracker. "[Violation Tracker 100 Most Penalized Current Parent Companies.](#)" Accessed August 2023. Two-thirds (67 percent) of those fines, or \$218 billion, were imposed on U.S. headquartered banks.

risk measurement are thus very much necessary to enhance banks' safety and soundness. Mayra Rodriguez Valladares of MRV Associates testified that:

Operational risk often plays a very significant role in the cause of a banking crisis. And it certainly played a big part in the 2007-2009 financial crisis as exemplified by cases of internal and external fraud, over dependence in models, and lack of due diligence in lending and securitization underwriting. For fifteen consecutive years, concern about cyber risk security has been in the top ten operational risk concerns of institutions in the financial industry; presently it is the top concern.<sup>67</sup>

The proposed operational risk requirement would be calculated using a business indicator metric and related financial statement calculation designed to capture the volume of activities that carry operational risks. According to the Federal Reserve, improving the performance of operational risk models would enable bank risk managers "to make more informed risk decisions by better matching economic capital and risk appetite and allows regulators to enhance their understanding of banks' operational risk."<sup>68</sup> This would also include an internal loss multiplier that serves as a proxy measure for an institution's risk profile. The internal loss measure is an indicator of the aggregate historical operational risk losses in relation to the size of the institution.<sup>69</sup> The proposal would appropriately establish a floor of 1 for the internal loss multiplier so that a firm's lower experience of operational losses cannot drive a decline in operational risk requirements. The banking industry, and in particular the megabanks, have been most critical of the internal loss multiplier among all the operational risk provisions in the proposal. This may be, at least in part, due to the high frequency and impact of operating errors among the megabanks reflected in the high fines noted above.

AFREF also supports two other improvements to the treatment of operational losses. The first includes reporting total net operational losses for capital purposes in the quarter in which their accounting impacts were recorded (rather than aggregated into a single event date), which better aligns with sound accounting principles. The proposal uses a ten-year average for annual total net operational losses to prudently balance a banking organization's operational risk exposure changes over time while smoothing the volatility that would result from shorter time periods.

Secondly, the proposal's internal loss multiplier calculation considers operational losses net of related recoveries. The latter are inflows of funds or economic benefits received from a third party related to an operational loss event. This would appropriately strengthen the measure by not allowing credit for offsets associated with recoveries, for example from insurance policies that mitigate the financial impact of losses associated with operational risk events. This is an important provision at a time when insurance companies are increasingly withdrawing from certain geographic markets because of the magnitude of climate impacts.

#### **IV. The proposal would establish long awaited capital cushion to absorb outsized market risk losses, particularly among the largest capital markets and trading firms**

The proposed rule includes stronger capital requirements for market risk that are necessary to prevent outsized, inadequately capitalized risk-taking in the capital markets. While there are economic consequences to higher

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<sup>67</sup> Rodriguez Valladares, Mayra. Testimony before the Subcommittee on Financial Institutions and Monetary Policy. House Financial Services Committee. U.S. Congress. "[A Holistic Review of Regulators: Regulatory Overreach and Economic Consequences.](#)" September 19, 2023 at 21.

<sup>68</sup> Curti, Filippo, and Marco Migueis. Federal Reserve Board. "[The Information of Past Losses in Operational Risk](#)" Finance and Economics Discussion Series. August 11, 2022 at abstract.

<sup>69</sup> Carrivick, Luke. Operational Riskdata Exchange Association. "[Fed Announces Basel III Endgame.](#)" August 1, 2023.

market risk capital, its absence also has costs. The costs of inadequately capitalized banks fall on families that bear the brunt of financial crises. Banks have been rewarded by a framework that incentivizes CEOs and their top business producers to take big risks without the commensurate capital cushion to absorb related losses. The proposed rule remedies the shortcomings of prior frameworks that effectively incentivized excessive market risk-taking.

The record of the 1996 Basel market risk amendment demonstrates the longstanding shortcomings of market risk measures.<sup>70</sup> From the early days of the U.S.'s risk-based standards for market risk in 1996, there were technical challenges to capturing different aspects of market risk and problems created by the increasingly insufficiently stringent risk weights assigned for some of the risks that were captured. Using higher risk weights in the standardized approach is necessary to reflect the greater loss severity associated with risky products, especially the most severe losses, known as tail risk. As the proposal notes: “[t]his became evident during the 2007-2009 financial crisis, when the 1996 rule did not fully capture banking organizations’ increased exposures to traded credit and other structured products such as collateralized debt obligations, credit default swaps, mortgage related securitizations, and exposures to other less liquid products.”<sup>71</sup>

After the crisis, the first round of Basel III changes raised the required capital levels of market risk to absorb losses in stressed conditions by incorporating stressed conditions into the Value at Risk measure and by increasing model standards. These changes addressed certain pressing deficiencies — like factoring in the need to size capital to provide an appropriate cushion under stressed conditions — but several deficiencies remained unaddressed related to the capture of extreme tail risk associated with low probability, but high impact events.

The proposed rule increases market risk capital requirements to better capitalize products and market activity that experienced historically steep losses in the period 2007 to 2008 peak to trough, with the products experiencing the steepest losses in 2008 the ones impacted in the proposal.<sup>72</sup> Industry critics have suggested that the proposal could lead to a loss of market share or reduced funding.<sup>73</sup> But, in reality, the current Basel III capital rule undercapitalizes and thus underprices risks. The most impacted business activities are those that cost the public and businesses far more in a financial crisis.<sup>74</sup>

The products most impacted by the changes are those that have sustained severe losses in financial crises; they have also been big money makers for the megabanks before crises:

- **Securitized products trading** purportedly lowers borrowing costs for businesses, diversifies and reduces the concentration of risk in the financial system, and strengthens market liquidity.<sup>75</sup> However, the rise of securitization has led to a principal-agency problem where lenders pay less regard to the quality of loans

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<sup>70</sup> The 1996 Market Risk Amendment introduced an explicit capital cushion for the market risks to which banks are exposed because of their trading in equities, debt securities, foreign exchange, commodities, options, etc. It allowed banks to use their internal rating models to estimate their market risks.

<sup>71</sup> [88 Fed. Reg. 179](#) at 64091.

<sup>72</sup> Ryan, Peter and Guowei Zhang. Securities Industry and Financial Markets Association. [“A Rejoinder on the Need for Trading Book Capital Increases: Federal Reserve Vice Chair Barr’s Speech on Capital: Part VIII in Our Series on US Bank Capital Requirements.”](#) October 12, 2023.

<sup>73</sup> Hopper, Greg. Bank Policy Institute. [“How Can the New Market Risk Capital Requirements Be Fixed?”](#) September 25, 2023.

<sup>74</sup> Senior Supervisors Group. [“Risk Management Lessons from the Global Banking Crisis of 2008.”](#) October 21, 2009.

<sup>75</sup> Ryan, Peter and Guowei Zhang. Securities Industry and Financial Markets Association. [“A Rejoinder on the Need for Trading Book Capital Increases: Federal Reserve Vice Chair Barr’s Speech on Capital: Part VIII in Our Series on US Bank Capital Requirements.”](#) October 12, 2023.

they are making since they can then sell those loans to a third party investor who is less familiar with the original underwriting process, a model often referred to as “originate-to-distribute.”<sup>76</sup> A complete breakdown from the misalignment of incentives between the underwriter of the loan and the end investor of the securitization was most notably seen in subprime mortgage securitizations, where losses ranged from 62 percent to 99 percent during the financial crisis depending on their credit rating.<sup>77</sup> Securitizations have also served as a way for capital sensitive investors such as banks and insurance companies to invest in riskier assets but at lower capital charges due to certain classes of securitizations receiving more favorable ratings than the underlying assets themselves.<sup>78</sup> The broader impacts included millions of homeowners wrongfully losing their homes, and trillions of dollars of lost multi-generational wealth that disproportionately impacted Black, Latinx, and other underserved and disadvantaged families.<sup>79</sup>

- **Derivative transactions** are used by U.S. businesses and other end-users to hedge financial risks, and derivatives have been highly profitable for the large banks that dominate the business.<sup>80</sup> However, derivatives have prompted losses in a range of high-profile instances and resulted in numerous lawsuits against the five independent investment banks.<sup>81</sup> For example: Orange County and Barings were put into bankruptcy through problem derivatives in the mid to late 1990s.<sup>82</sup> Enron was the poster child of fraudulent swap activity that put Enron out of business and paved the way to billions of dollars of losses at Citigroup and JPM Chase<sup>83</sup>; derivatives played a role in Lehman Brothers’ failure in September 2008<sup>84</sup>; and the credit default swap market sustained trillions in notional losses during the financial crisis, precipitating AIG’s collapse in September 2008 as a major seller of credit default swap protection.<sup>85</sup>

In 2012, JPMorgan Chase investment officers evaded policies, reporting and other controls to accrue losses in commodities derivatives that cost the firm \$6.2 billion. Further, swaps played a key role in Archegos’ failure and billions in losses across the major prime brokers in 2021, most notably Credit Suisse sustaining a billions of dollars in losses, that contributed to its slow descent and failure in the spring of 2023 due to market turbulence magnified in the aftermath of the SVB and other bank failures.<sup>86</sup> Archegos, reportedly with net assets of between \$10 billion and \$20 billion, may have had actual exposures of

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<sup>76</sup> Bord, Vitaly M. and João A.C. Santos. Federal Reserve Bank of New York. [“The Rise of the Originate- to-Distribute Model and the Role of Banks in Financial Intermediation.”](#) FRBNY Economic Policy Review. July 2012.

<sup>77</sup> Ospina, Juan and Harald Uhlig. National Bureau of Economic Research. [“Mortgage-Backed Securities and the Financial Crisis of 2008: A Post Mortem.”](#) Working Paper No. 24509. April 2018.

<sup>78</sup> Segoviano, Miguel et al. International Monetary Fund. [“Securitization: The Road Ahead.”](#) IMF Staff Discussion Note. January 2015.

<sup>79</sup> Famighetti, Christopher and Darrick Hamilton. Economic Policy Institute. [“The Great Recession, education, race, and homeownership.”](#) May 15, 2019.

<sup>80</sup> Ryan, Peter and Guowei Zhang. Securities Industry and Financial Markets Association. [“A Rejoinder on the Need for Trading Book Capital Increases: Federal Reserve Vice Chair Barr’s Speech on Capital: Part VIII in Our Series on US Bank Capital Requirements.”](#) October 12, 2023.

<sup>81</sup> This includes [Merrill Lynch, Goldman Sachs, Bear Stearns \(shareholders\), Morgan Stanley and Lehman Brothers.](#)

<sup>82</sup> [“Barings files for bankruptcy in \\$789-million investment loss.”](#) *Los Angeles Times*. February 27, 1995,

<sup>83</sup> Behr, Peter. [“Enron’s lenders face huge losses.”](#) *Washington Post*. November 30, 2001.

<sup>84</sup> Fleming, Michael J. and Asani Sarkar. Federal Reserve Bank of New York. [“The Failure Resolution of Lehman Brothers.”](#) *Economic Policy Review*. Vol. 20, No. 2. December 2014.

<sup>85</sup> McDonald, Robert and Anna Paulson. Kellogg School of Management. Northwestern University. [“What went wrong at AIG.”](#) *Kellogg Insight*. August 3, 2015.

<sup>86</sup> Harding, Robin. [“SVBs collapse was one thing, Credit Suisse’s quite another.”](#) *Financial Times*. May 30, 2023; Postel-Vinay, Natacha. [“Until bankers have more to lose themselves, collapses like SVB and Credit Suisse will keep happening.”](#) *The Guardian*. March 21, 2023.

between \$50 billion and \$100 billion due to the additional leverage provided by investing in total return swaps, and its failure is estimated to have directly cost some of the world's largest banks some \$10 billion, with Credit Suisse and Nomura together losing almost \$7 billion.<sup>87</sup>

- **Securities borrowing transactions** are used to generate income for U.S. pensions and retirement funds and help increase market liquidity.<sup>88</sup> A substantial reliance by financial institutions on secured funding markets to finance either lesser quality or more opaque assets fueled the substantial losses that contributed to Bear Stearns and Lehman Brothers' collapses in 2007 and 2008 respectively.<sup>89</sup>

***The proposed regulatory scope would cover additional banking organizations that have enough market risk in their business activities to make market risk control and market risk capital key to safety and soundness (Question 80)***

The proposed rule would cover more transactions and firms to appropriately raise capital requirements to account for market risk. The proposal raises the threshold for coverage, to account for inflation, it expands the capital requirements to cover more transactions and exposures, and it covers additional market positions to more accurately reflect actual trading risks. Currently, the framework only applies to banking organizations with \$1 billion or more in aggregate trading assets and liabilities or 10 percent or more of the banking organization's total assets. The proposal would adjust the current applicability scope to capture uncovered aspects of market risk (such as short positions resulting from hedging overages) and by raising the dollar threshold of applicability from \$1 billion to \$5 billion, which adjusts the threshold for inflation and growth in the capital markets since the 1996 Market Rule was passed.

The proposal would also expand coverage of additional types of transactions, exposures, and total risk weighted assets, particularly for large trading and capital markets firms. The proposal would appropriately cover equity positions in investment and private funds, not just mutual funds, considering the significant risks in these prospect relationships as borne out by Bear Stearns' failure led by losses in its asset management arm.<sup>90</sup> AFREF recommends expanding the scope of coverage beyond those funds for which a banking organization has access to the fund's investment limits. All types of equity positions should be subject to regulatory capital requirements under the proposed market risk framework and firms should obtain the relevant information needed to conform to the final rule.

AFREF additionally supports certain new items in the definition of in-scope positions that capture aspects of market risk not categorized as trading assets or liabilities. This would include certain equity positions in an investment fund and net short hedging related positions (if over \$20 million). This also includes certain publicly traded equity positions that are restricted (e.g. due to deferred compensation) and certain embedded derivatives that relate to credit or equity risk and that the organization bifurcates for accounting. Including these investments is critical to establish capital levels that fully capture banking organizations' market risks.

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<sup>87</sup> Ong, Li Lian and Wei Sun. ASEAN+3 Macroeconomic Research Office. "[Is Archegos the tip of another looming systemic iceberg?](#)" *Asia Times Financial*. April 25, 2021.

<sup>88</sup> Ryan, Peter and Guowei Zhang. Securities Industry and Financial Markets Association. "[A Rejoinder on the Need for Trading Book Capital Increases: Federal Reserve Vice Chair Barr's Speech on Capital: Part VIII in Our Series on US Bank Capital Requirements.](#)" October 12, 2023.

<sup>89</sup> Senior Supervisors Group. "[Risk Management Lessons from the Global Banking Crisis of 2008.](#)" October 21, 2009.

<sup>90</sup> Egan, Matt. "[The stunning downfall of Bear Stearns and its bridge-playing CEO.](#)" *CNN*. September 30, 2018.

***The proposal's four-quarter rolling average for the \$5 billion aggregate trading assets and trading liabilities threshold reduces the incentive for firms to game the system during certain times of year (Question 81)***

The proposal's \$5 billion and 10 percent trading threshold would be set to a four-quarter rolling average, which smooths out quarterly trading volatility and discourages firms from trying to game their quarterly trading to exclude capital rule coverage. The four-quarter rolling average would improve agencies' identification of banking organizations with significant levels of trading activity. The current calculation of trading activity and whether it meets the \$5 billion threshold, is based on a single snapshot once every 12 months, which incentivizes firms to reduce their trading book when the calculation is captured. A threshold determination based on rolling averages, on the other hand, does not allow firms to avoid high exposures during a designated reporting date, only to resume higher positions after that date has passed.

A banking organization would remain subject to market risk capital requirements unless and until the average falls below the trading activity threshold criteria for the average of the prior four consecutive quarters (or is no longer a banking organization subject to the large bank capital standards). The rolling average threshold improves the agencies' ability to monitor whether a firm's trading activities exceed these thresholds from a dollar or from a percentage basis and it discourages any efforts a firm might undertake to keep exposures low during a shorter threshold measurement window.

***The proposal appropriately includes net short hedging positions to capture of market risk, incorporates into capital requirement hedge overages that can enhance profit and loss statements (Questions 85 to 86)***

AFREF supports the proposal's inclusion of net short positions related to hedging in assessing market risk. It is not uncommon for a firm to maintain a hedge position that at times exceeds the underlying exposure being hedged that results in a net short position in the hedge exposure. This can result in unanticipated losses to a banking organization in a downside scenario. It can be used to take a proprietary position prohibited by Volcker Rule, if the short is not appropriately recognized and capital not held against the position.

The proposal would appropriately cover net short risk positions that result from "over-hedges" of credit and equity exposures that are not market-risk covered positions. As the proposal describes, since the hedged exposures are not traded, these net short risk positions would not meet the definition of trading position, even though they expose the banking organization to market risk. The proposal's inclusion of net short risk positions in market risk covered positions would require firms to appropriately capitalize these positions.

To calculate the exposure amount of a net short risk position, the proposal would require a comparison of the notional amounts of a banking organization's long and short credit positions and the adjusted notional amounts of its long and short equity positions that are not market risk covered positions. For the purposes of this calculation, the notional amounts would include the total funded and unfunded commitments for loans that are not market risk covered positions. Additionally, the proposal would require a banking organization to identify separately net short risk positions for single-name exposures and for index hedges, as a banking organization may hedge exposures at either the single-name level or the portfolio level.

AFREF agrees with the establishment of a threshold to exclude short positions under a certain level of materiality. The proposal would limit the application of the proposed market risk capital requirements to positions arising from exposures for which the notional amount of a short position exceeds the notional amount of a long position by \$20 million or more at either the single-name or index hedge level. The proposed \$20 million threshold would appropriately identify significant net short risk exposures that warrant capitalization under the market risk framework, striking a balance between over-hedging concerns and aligning incentives for banking organizations



to prudently hedge and manage risk while capturing positions for which a market risk capital requirement would be appropriate.

***The proposal's addition of internal risk transfers would incentivize appropriate risk mitigation activities, which are a critical tool for managing and controlling market risk (Questions 90 to 92)***

The proposal would improve upon the current framework by covering banking organizations' internal transfers of risk when a trading desk arranges the hedge for an affiliated banking unit. A banker may ask the trading desk of an affiliated broker-dealer to hedge the banking unit's interest rate risk. The affiliated trading desk typically obtains the hedge in the relevant capital market and moves the risk position to the banking unit through an internal transfer. Hedging transactions of this kind may be invisible to an external party but can nonetheless pose a significant source of market risk that should be managed and controlled for their daily impact on the hedged entity's profit and loss.

The current capital framework does not address internal transfers of this kind from a banking unit (or CVA desk) to a trading desk within the same banking organization. A good example, as the proposal notes, is a hedge relationship between a mortgage banking unit and an interest rate trading desk. In the current framework, market risk-weighted assets do not reflect the market risk of such internal transactions and capture only the external portion of the hedge, potentially misrepresenting the risk position of the banking organization. Any operational burden should be achievable and absorbed as a necessary cost of being able to arrange hedging transactions with affiliates.

***The proposal would introduce a definition of a trading desk appropriate for adoption of the capital requirements and accompanying methodology and data, oversight, and control of internal estimation models down to the trading desk level (Questions 99 and 101)***

The proposed enhancements to trading desk definition better capture market risk and market risk management and control, which are important for the safety and soundness of the largest banks, particularly those with large scale trading and capital markets businesses. The proposal would appropriately define a trading unit as one that purchases or sells market risk positions and: 1) has a well-defined strategy; 2) is structured appropriately for monitoring and review of hedging strategies and limits; 3) has a unified approach, including common metrics, risk levels and joint trading limits, and 4) submits management reports and books trades together. These make sense, are appropriate and would likely align with common trading desk configurations that conform with the Volcker rule and capital markets specific rules and regulations.

The proposal would require trading businesses that want to continue using internal models to adhere to more robust controls related to profit and loss attribution and back-testing down to the trading desk level. These are solid improvements. The agencies should also look for ways that existing Volcker-rule focused trader mandates and model inventories and controls could be leveraged to encompass the standards in this proposal. GSIBs already maintain the two main types of controls that work in concert to strengthen internal models' reliability and documentary evidence of the internal models' effectiveness. These include profit and loss attribution and back-testing, requirements that have been in place conceptually since the market risk amendment of 1996. AFREF generally opposes the use of internal models because they are opaque and subject to manipulation. However, in this instance, the use of internal models makes sense when used safely with appropriately high guardrails.

Foreign-headquartered banking organizations with cross-border operations could face difficulties in applying the proposed trading desk definition and would likely seek to apply trading desk designations consistent with their home country's regulatory requirements, provided those requirements are consistent with the Basel III reforms.

The more the U.S. proposed Basel III trading desks rules align with other international existing configurations and make sense to the trading desks, the sooner the controls can be adopted and the greater likelihood they will be designed and operate effectively. The trading desk approach gives businesses sufficient flexibility to align their designated trading desk configuration based on their existing needs and consistent with other capital markets regulatory requirements.

In addition, the proposal would allow a banking organization to establish a dedicated notional trading desk for conducting internal risk transfers to hedge interest rate risk. The dedicated desk would assist with what the proposal characterizes as the complexity of tracking the direction of internal transfers of interest rate risk. This is important as lending and trading-related interest rate risk is one of a typical bank's top financial risks as a financial intermediary. The rationale is to introduce a notional trading desk to address the issue of certain trading desk level requirements not being applicable to these types of activities and positions that the proposal would include as covered positions. This would allow firms the flexibility to house certain activities generating market risk but not during normal business trading. Examples given in the proposal are the ones added to the definition of covered market risk position, irrespective of whether they are trading assets and liabilities, including net short positions, embedded derivatives that are bifurcated for accounting purposes, as well as selected foreign exchange and commodities exposures that are not publicly traded.

The proposal should be strengthened to tighten the oversight of the impact of these trades on market risk and capital levels. The proposal would permit firms to trade in these notional trades to establish a market for the positions. While granting this authority, the agencies should monitor these desks' gross exposures, not just net exposures, for unintended consequences, including those that are "inter-bucket" described below. Similar to other qualifying trading desks, the notional desk should monitor, and deliver to senior management a level of granular reporting on gross exposures of all kinds. This level of granular reporting would be necessary to identify the kinds of rogue traders that plagued Barings in 1995, Société Générale in 2008 and UBS in 2011.<sup>91</sup> These respective losses or collapses might have been reduced or prevented if an independent control function had monitored more granular levels of exposure, for example the gross trading exposures, not just net exposures, of key trading desks.

The agencies should allow internal modeling permitted under the proposal, where determined to be appropriate for use and fit for purpose,<sup>92</sup> to inform a banking business and its risk oversight counterparts about the risk profile of the firm. The agencies should not automatically cap the internal model measure's total capital requirement when the capital requirement exceeds the calculation for the standardized amount required for such desks. If the firm has established effective internal modeling that meets the proposal's robust controls, and internal audit and the firm's supervisors have validated these models, then the model output should be applied when it indicates that capital amounts should exceed what the standardized model would estimate for the same exposures. The agencies should only apply discretionary caps on a one-off basis. A blanket cap would detract from the full benefits of adhering to both approaches, such as for informing hedging strategy.

***The proposal's market risk add-on feature would provide trading desks with a third approach if their model oversight and control limitations prevent them from initially qualifying for either of the two approaches (Question 105)***

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<sup>91</sup> Clark, Nicola and David Jolly. "[Société Générale loses \\$7 billion in trading fraud.](#)" *New York Times*. January 24, 2008; Shirbon, Estelle. "[UBS trader jailed for seven years in \\$2.3 billion fraud.](#)" *Reuters*. November 20, 2012; Smith, Elliot. "[The Barings collapse 25 years on.](#)" *CNBC*. February 26, 2020.

<sup>92</sup>Based on independent review by an internal audit department deemed effective by the supervisor, or a review conducted by the relevant supervisory agency itself.

The proposal appropriately recognizes that, particularly with higher governance and control standards for trading desks, some trading units may not initially qualify for either the standardized approach or the internal model approach. The fallback approach would require prior regulatory approval and only be permitted when trading desks do not qualify for either of the internal models and the revised standardized approach. This would allow for separate capital treatment that is appropriately conservative. As the proposal stipulates, the fallback would be like the current treatment for exposures that are considered to be de minimis. This fallback capital requirement equals the sum of the absolute fair value of each position subject to the fallback capital requirement, unless approved for some alternative approach.

***The proposal would improve the sensitivities method, market risk curves, and liquidity horizons in the standardized approach that would raise required capital levels for select capital markets and trading intensive businesses (Questions 110 to 111)***

AFREF supports improvements to the standardized method that would replace internal models-based methodologies. The revised standardized method is sensitivities-based, similar to a simple stress test where a banking organization estimates the change in the value of its market risk positions by applying standardized shocks with each prescribed risk weight calibrated (or adjusted) to a defined liquidity time horizon and consistent with the expected shortfall measurement framework under stressed conditions. The proposal would establish a process that:

- assigns market risk positions to risk classes<sup>93</sup> and establishes risk factors for market risk covered positions within the same risk class;
- describes the method to calculate the sensitivity of a market risk covered position for each of the prescribed risk factors (such as interest rate, equity, foreign exchange, commodities, as well as credit spread risks); and
- describes the shock applied to each factor and the process for aggregating the weighted sensitivities within each risk class and across risk classes.

The proposal would also require trading desks to construct appropriate yield curves. As the proposal notes, the banking organizations with material exposure in less liquid markets and that take on exposure to certain exotic or less common risks should have the capabilities to measure and monitor those products with a constructed yield curve. That yield curve should account for individual classes of exposure for which loss estimation is measured. For example, trading desks dealing in emerging market currencies should have capabilities to construct distinct onshore and offshore curves. The operational burden should be considered a basic cost of engaging in the less common financial market.

***Effective backtesting and profit and loss attribution would play a key role in maintaining high standards for the quality and relevance of outputs from internal market risk models (Questions 154 and 155)***

The proposal would expand requirements for backtesting, where use of internal models is permitted. An effective backtesting program looks at historical daily market estimations of mark-to-market (MTM) losses in traded products and assesses how effective the daily estimation of loss is relative to actual MTM results based on the

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<sup>93</sup> The prescribed risk classes in the proposal, based on standard industry definitions, are interest rate risk, credit spread risk, equity risk, commodity risk, and foreign exchange risk. Credit spread is further disaggregated into credit spread risk for correlation trading positions, credit spread for securitizations that are not correlation trading positions, and credit spread risk for non-securitized positions.

historic daily market movements. An effective profit and loss attribution would robustly explain what types of market risk (including interest rate risk, equity risk, credit spread risk, commodity risk and foreign exchange risk) contributed to the profit or loss a firm sustained in its traded portfolios on a given day. If a particular trading desk cannot meet the heightened standards for backtesting and profit and loss attribution, as the proposal notes, the failure of these tests would obligate a bank to switch to the revised standardized approach, which incorporates more conservative assumptions on what constitutes steep enough losses during a period of heightened market volatility to require additional capital reserves.

***The proposal introduces aggregation formulas that would dramatically reduce diversification benefits relative to the current capital framework, notably by limiting the risk mitigating benefit of hedges and diversification (Question 171)***

The proposal's very limited recognition of the risk mitigating benefit of hedges and diversification benefits is appropriate, considering the unreliability of the relationship between the underlying position and its hedge. The agencies should not give in to industry pressure to provide diversification benefits where the benefits to diversification between certain assets have proven to evaporate during periods of stress. The seven prescribed risk classes, based on standard industry classifications, are interest rate risk, credit spread risk for non-securitization positions, credit spread risk for correlation trading positions, credit spread risk for securitization positions that are not correlation trading positions, equity risk, commodity risk, and foreign exchange risk. For each of these seven risk classes, the proposal designates individual assigned risk buckets that would capture common risk characteristics that are highly correlated and therefore affect the value of a market risk covered position in substantially the same manner.

As the proposal notes, once the risk buckets are identified, the bank would have to map the positions to the appropriate risk factors within each risk bucket. The megabanks with large-scale market risk operations would need to track and map a range of correlations between capital markets positions. However, the relationships between these different capital markets positions, for example any diversification benefits from negative correlation of the associated risks, are prone to change during periods of stress. The proposal would provide a process to bring consistency to the seven risk classes and correspond to industry practice, as large trading banking organizations are familiar with bucketing structures like the ones set forth in the proposal.<sup>94</sup>

***The proposal would appropriately provide a three-year phase-in for the changes to the credit, market, operational, and credit valuation adjustment risk capital requirements (Question 173)***

AFREF agrees with the timeline and phasing in of risk weighted assets under the proposal. In the first year, U.S. banking organizations would be required to recognize 80 percent of the changed amount of risk-weighted assets, stepping up to 85 percent in year two, 90 percent in year three, and 100 percent thereafter. The agencies should not allow industry attempts to extend or otherwise ease the transition period for this rulemaking, particularly considering most of the provisions have been under discussion with substantial industry input since well before the 2017 Basel III endgame release.

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<sup>94</sup> The proposal would establish the following process to determine the sensitivities-based capital requirement for the portfolio in a manner that consistency in the application of risk-based capital requirements across banking organizations: (1) assign market risk covered positions to risk classes and establish the risk factors for market risk covered positions within the same risk class; (2) describe the method to calculate the sensitivity of a market risk covered position for each of the prescribed risk factors; (3) describe the shock applied to each risk factor; and, (4) describe the process for aggregating the weighted sensitivities within each risk class and across risk classes. Under the proposal, a banking organization would assign each market risk covered position to one or more risk buckets within appropriate risk classes for the position.

. . .

AFREF believes capital levels for large banking organizations, especially the megabanks, should be substantially higher than they are under the current Basel III implementing rules. Increasing large banks' equity capital requirements is the most effective mechanism to reduce the risk of failure and systemic risk and bolster the confidence of depositors, investors, counterparties, and the public in the banking system. Stronger capital levels are essential to make the financial system more resilient. Anat Admati of Stanford Business School observed:

Increasing equity requirements substantially brings about numerous benefits beyond increasing loss absorption capacity that allows banks to continue making loans after incurring losses without needing support. With more equity, liquidity problems, runs and all forms of contagion are less likely. Moreover, any loss in the value of the assets is a smaller fraction of the equity, thus fewer assets must be sold under distressed conditions to 'delever.' Better yet, distortions in banks' lending and funding decisions due to overhanging debt are alleviated. As another bonus, more equity is the best way to reduce the implicit guarantees subsidy that distorts markets and rewards recklessness.<sup>95</sup>

The proposed Basel III Endgame regulation — with suggested improvements — is essential to strengthen regulatory capital to prevent runs on banks' liabilities, support orderly resolutions, and strengthen the financial system. We support the fundamental components of the proposal, and recommend important but very limited revisions, notably to mortgage risk weights. More robust capital standards are the best possible tool regulators have to strengthen the safety and soundness of the financial system and protect families from the terrible consequences of instability and collapse.

Thank you for the opportunity to comment and for the consideration of these recommendations in the development of a final rule.

Sincerely,  
Americans for Financial Reform Education Fund

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<sup>95</sup> Admati, Anat R. Stanford University School of Business. [“The Missed Opportunity and Challenge of Capital Regulations.”](#) Working Paper No. 2286, December 2015 at 8.