

*January 15, 2024*

*Re: Notice of Proposed Rule Making “Regulatory capital rule: Amendments applicable to large banking organizations and banking organizations with significant trading activity.”*

*Office of the Comptroller of the Currency (OCC), Docket ID OCC–2023–0008*

*Department of the Treasury, RIN 1557-AE78*

*Federal Reserve System, RIN 7100-AG64*

*Federal Deposit Insurance Corporation, RIN 3064-AF29*

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I appreciate this opportunity to respond to the Notice of Proposed Rule Making by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation seeking information from the public regarding its proposed rule changes to regulatory capital requirements for banking institutions with more than \$100 billion in assets.

## **Background**

A capital buffer protects depositors against loss when a bank’s assets—loans made from deposits—default. The capital adequacy ratio is determined by dividing eligible capital by risk-weighted assets (RWAs). Riskier assets are assigned a greater weight— a percentage multiplied by the actual value of the asset. The greater the risk, the greater the weight applied to the asset— and the greater the amount of capital needed to protect against the risk. Cash receives a 0 percent risk weighting as a completely risk-free asset. On the other end of the risk scale, a bank’s equity investment in a publicly traded security is weighted up to 300%. Most residential home mortgages are weighted at just 50%.<sup>1</sup> This proposed rule would eliminate the use of large banking organizations’ internal models to set regulatory capital requirements and would substantially increase the capital requirements for residential home mortgages.

### **I. Arbitrarily and capriciously prohibits banks from using internal models for determining risk capital requirements.<sup>2</sup>**

Current rules allow banks to use internal modeling to estimate probability of default (PD) and loss given default (LGD) of specific loans in their portfolios.”<sup>3</sup> PD estimates the probability of default of loan held throughout the economic cycle—including growth, peak, recession, and trough. LGD is based on what would likely be recovered through the bankruptcy process during a recession. Capital requirements for these loans are determined by plugging PD and LGD into formulas provided by the banking regulators.

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<sup>1</sup> National Credit Union Administration, <https://ncua.gov/regulation-supervision/regulatory-compliance-resources/risk-based-capital-rule-resources/risk-weights-glance>.

<sup>2</sup> Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf>.

<sup>3</sup> As defined by the Federal Reserve, a model refers to “a quantitative method, system, or approach that applies statistical, economic, financial, or mathematical theories, techniques, and assumptions to process input data into quantitative estimates.” <https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm>

Estimates by internal models of PD and LGD differ amongst banks for similar loans for a range of reasons. These internal models attempt to reflect the impact of their individualized banking operations, legal remedies utilized in the event of a default, and risk mitigation of their existing loan portfolios. The risks stemming from default for a loan with identical parameters to an identical borrower may indeed vary based on different practices between competing banks. For good reason, internal models may yield differing estimated risk of loss based on a bank's knowledge of their own processes. Importantly, diminishment of PD and LGD results in lower amounts of capital required based on the formulas dictated by the agencies, enhancing profitability.

The agencies claim these variations in internal modeling result in “unwarranted” variations of risk capital requirements for loans made to similar or identical companies by different banks. In place of this internal modeling, the agencies propose a standardized approach for determining PD and LGD.

The agencies' conclusion that the variations are “unwarranted” is arbitrary and capricious.”<sup>4</sup> The only evidence cited by the Agencies in support of this conclusion are the 2013 and 2016 studies Basel Committee on Banking Supervision.<sup>5</sup> Neither of these studies establish that variations between internal modeling results are “unwarranted.”

The 2013 Basel study notes, “The study did not attempt to identify an appropriate or acceptable level of variation of RWA in the banking book and its findings are sensitive to a number of assumptions.”<sup>6</sup> Far from suggesting that a standardized approach to estimating PD and LGD, the 2013 Basel study warned, “A significant challenge for this work is the fact that ‘true’ levels of underlying risk are unknown.” The authors further cautioned that although the analysis “is able to identify differences in RWA across banks,” they “cannot determine whether these differences correspond to differences in underlying risk.”<sup>7</sup> The 2013 Basel study expressly advises, “[T]hese caveats suggest that a degree of caution should be exercised when interpreting the results in this section.”<sup>8</sup> The 2013 Basel study further stated that internal modeling may yield two “very different RWAs for superficially similar portfolios that are in fact different in risk.”<sup>9</sup>

The authors acknowledged that the available data was insufficient to “identify and assess” these differing risk management practices that are responsible for some of these internal modeling variations.<sup>10</sup>

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<sup>4</sup> Proposed “Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity,” <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf>, p. 64031.

<sup>5</sup> Ibid, p. 64031.

<sup>6</sup> Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP), “Analysis of risk-weighted assets for credit risk in the banking book,” July 2013, <https://www.bis.org/publ/bcbs256.pdf>, p. 4 (accessed January 15, 2024).

<sup>7</sup> Ibid., p. 12.

<sup>8</sup> Ibid., p. 12.

<sup>9</sup> Ibid., p. 12, footnote 22.

<sup>10</sup> Ibid.

Likewise, the 2016 Basel study cited by the agency reiterated that “the nature of the analysis used in this study, combined with material data limitations, does not allow for a definitive measure of how much observed variation in retail and SME RWAs is driven by differing practices or differences in risk.”<sup>11</sup>

Nonetheless, the Agencies instead cite these studies to conclude what its authors advise against: that the internal modeling differences of loss estimates for similar assets are “unwarranted” because they are not based on differences on underlying risks.

Furthermore, the Agency also fails to recognize that internal modeling may yield capital buffers in *excess* of actual portfolio risk, thus exceeding the minimum requirements under current regulations. The 2016 Basel study found that “[F]or most banks, on average, the PD parameters are higher than the actual default rates.”<sup>12</sup> LGD parameters “appear generally higher than actual losses.”<sup>13</sup>

These two studies comprise the sole citations for the Agency’s determination that that the variation of estimated PD and LGS amongst internal models is “unwarranted.” But these sources cited by the agency as justification for forcing banks to use a standardized model for determining PD and LGD fail to provide any such justification.

This determination is arbitrary and capricious.

Agencies already possess the power to review the internal risk models. Existing regulations already provide ample guidance for supervisors to “identify model limitations and produce appropriate changes.”<sup>14</sup> The Supervisory Guidance on Model Risk Management (SR 11-7) for banking organizations and supervisors issued by the Federal Reserve and Office of the Comptroller of the Currency (OCC) encompasses model development, implementation, use, validation, governance, policies, and controls.<sup>15</sup> Exercise of this supervisory power over internal modeling allows internal modeling to reflect the unique operations of individual banks while ensuring the model inputs are reasonable.

## **II. The Agency arbitrarily and capriciously ignores the dangers of standardizing the risk models.**

Standardizing the risk modeling disincentivizes more robust credit risk management. Lower capital costs stemming from lower PD and LGD estimated by internal models may exceed the additional resources devoted to this risk reduction. A standardized risk model presumes a loan by

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<sup>11</sup> Basel Committee on Banking Supervision, Regulatory Consistency Assessment Programme (RCAP), “Analysis of risk-weighted assets for credit risk in the banking book,” April 2016, conclusion, <https://www.bis.org/bcbs/publ/d363.pdf> (accessed January 15, 2024).

<sup>12</sup> *Ibid.*, p. 12.

<sup>13</sup> *Ibid.*, p. 16.

<sup>14</sup> Board of Governors of the Federal Reserve System, Supervision and Regulatory Letters, SR 11-7: Guidance on Model Risk Management, April 4, 2011, <https://www.federalreserve.gov/supervisionreg/srletters/sr1107.htm> (accessed January 15, 2024).

<sup>15</sup> Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, SR Letter 11-7 Attachment, Supervisory Guidance on Model Risk Management, April 4, 2011, <https://www.federalreserve.gov/supervisionreg/srletters/sr1107a1.pdf> (accessed January 15, 2024).

a bank with more robust credit risk management is just as risky as a similar loan made by another firm with less credit risk management. If required capital for a given loan will be identical regardless of the credit risk management system, a bank will be disincentivized from investing these resources because the cost savings from reduced capital requirements disappear.

The ability to rely upon internal modeling in determining PD and LGS allows each institution to engage in a tradeoff between more robust risk management and lower capital costs or less robust risk management and higher capital costs. Implementing a standardized risk model will perversely disincentivize risk management. Under a standardized risk model, additional risk management endeavors will no longer yield the benefit of lower capital costs as the amount of capital required will be identical regardless.

### **III. Arbitrarily and capriciously increases the capital requirements for residential home mortgages held by banks with more than \$100 billion in assets.**

Presently, all mortgages held by US banks are assigned a 50% risk weight, regardless of owner occupancy or loan to value (LTV). Based on the current “adequately capitalized ratio” requirements, a bank must set aside 5.25% in capital for a residential mortgage. The basic formula for this is as follows:  $(8\% \text{ risk-weighted asset capital ratio} + 2.5\% \text{ capital ratio}) * (50\% \text{ of mortgage value}) = 5.25\%$ . For a \$200,000 mortgage, a bank must retain \$10,500 of capital.

The proposed rule would increase the risk weight on most mortgages, including increasing the weight for residential mortgages of between 90% and 100% LTV to 95%.<sup>16</sup> Mortgages with the highest risk-weights will require capital at more than 5x the level of lower-LTV, owner-occupied residences in stark contrast to the current rules which apply capital requirements uniformly across all mortgages.

The increased cost of capital for high- LTV borrowers on a \$200,000 mortgage will easily exceed \$360 annually for those borrowers—potentially significantly more, depending on the cost of capital.<sup>17</sup> The economic impact analysis fails to acknowledge these consumer costs.

Independent analysis of historical losses from the 2005 to 2008 housing market collapse indicate that if a crisis of similar severity occurred now, the loss rate for high-LTV loans with FICO scores of under 700 would be substantially less than the proposed capital requirement to protect against losses on mortgage loans of this risk profile.<sup>18</sup> The agencies also fail to provide an analysis of how this significant increase in risk-weighting—and the resulting increase in capital

<sup>16</sup> Proposed “Regulatory capital rule: Amendments applicable to large banking organizations and to banking organizations with significant trading activity,” <https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf>, p. 64191.

<sup>17</sup> Goodman, Laurie, and Jun Zhu, “Bank Capital Notice of Proposed Rulemaking—A Look at the Provisions Affecting Mortgage Loans in Bank Portfolios,” Housing Finance Policy Center, The Urban Institute, September 2023, p. 7, <https://www.urban.org/sites/default/files/2023-09/Bank%20Capital%20Notice%20of%20Proposed%20Rulemaking.pdf> (accessed January 15, 2023).

<sup>18</sup> *Id.*, p. 6, “If the current bank loan portfolio were to go through a stress scenario similar to that of loans originated from 2005 to 2008 (the GSEs’ worst book of business), the expected loss would be 6.56 percent, which is 79 basis points lower than the NPR’s capital requirement of 7.35 percent. Similarly, we find that the loss rate for loans with LTV ratios from 80 to 90 percent, using the 2005–08 GSE loss experience and the 2020–21 bank portfolio composition, would be 5.54 percent, or 76 basis points lower than the NPR proposal.”

requirements—is justified by any corresponding estimated risk of loss in the event of default (PD and LGD).

The proposed rule also fails to account for risk mitigation provided by mortgage insurance or reinsurance. Proceeds from this insurance compensate the lender in the event of a default, diminishing reliance on bank capital to protect banks—and, ultimately, the depositors-- from mortgage default losses.

Sincerely,

Joel Griffith