

# COMMITTEE ON CAPITAL MARKETS REGULATION

January 16, 2024

Chief Counsel's Office  
Attention: Comment Processing (Docket ID OCC–2023–0008)  
Office of the Comptroller of the Currency  
400 7th Street SW, Suite 3E-218  
Washington DC 20219

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

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

## VIA EMAIL AND ELECTRONIC PORTAL

Re.: Docket No. R-1813, RIN 7100-AG64 - Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the “Committee”) offers these comments to the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the “Agencies”) on their proposed rule entitled “Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity” (the “Proposal”).<sup>1</sup>

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-eight leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Emeritus Dean, Columbia Business School) and John L. Thornton (Former Chairman, The Brookings Institution) and is led by Hal S. Scott (Emeritus Nomura Professor of International Financial Systems at Harvard Law

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<sup>1</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, TREASURY, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL DEPOSIT INSURANCE CORPORATION, *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity*, FED REG. Vol. 88. No. 179 (Sept. 18, 2023), <https://www.federalregister.gov/documents/2023/09/18/2023-19200/regulatory-capital-rule-large-banking-organizations-and-banking-organizations-with-significant> [the “Proposal”].

School and President of the Program on International Financial Systems). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Our letter proceeds in two parts.

Part I describes how the Proposal would make major reforms to the minimum capital requirements for large banks that will significantly increase their required capital. It also identifies various respects in which the Proposal goes beyond what Basel III requires – a practice referred to as “gold plating.”

Part II assesses the Proposal’s changes. We first show that the Proposal’s “Impact and Economic Analysis” is entirely insufficient to support the conclusion that the Proposal’s benefits would outweigh its costs. We then review the empirical evidence showing that the Proposal’s costs would instead significantly outweigh its benefits. More specifically, this evidence shows that the capital increases resulting from the Proposal would be unnecessary, since U.S. bank capital levels are already strong. These capital increases would also be counterproductive, by reducing lending and capital markets activities and increasing disintermediation – that is, the process by which lending and capital markets activities move from the bank to the nonbank sector. The evidence also shows that even though the Proposal would not come into effect until 2025, announcing an increase in capital requirements under the current economic conditions could interfere with the Fed’s monetary policies. We therefore recommend that, *if* the Agencies choose to finalize the Proposal, then the implementation date should be delayed until economic conditions are more stable. Second, we identify specific issues with the Proposal and make recommendations for how policymakers could address these issues, including by rolling back gold-plating and addressing duplicative requirements.



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**I. OVERVIEW OF THE PROPOSAL**

Subpart 1 overviews the rules that currently determine large banks’ capital requirements. Subpart 2 describes how the Proposal would change these rules to substantially increase minimum capital requirements for banking organizations with more than \$100 billion in assets and other banks with “significant trading activity.” We highlight respects in which the Proposal adopts standards that are more stringent than the international capital standards issued by the Basel Committee (“Basel III”), a practice referred to as “gold plating.”

**1. Summary of current capital requirements**

Federally supervised banks are subject to three principal capital requirements: (A) minimum risk-based capital ratios, (B) risk-based capital buffers, and (C) minimum leverage ratios.<sup>2</sup>

*A. Minimum risk-based capital ratios*

There are three minimum risk-based capital ratios: (1) a common equity tier 1 (“CET1”) capital ratio of 4.5%, (2) a tier 1 capital ratio of 6%, and a (3) a total capital ratio of 8%.<sup>3</sup>

- The numerator of the CET1 capital ratio is CET1 capital, which consists of a bank’s common stock and retained earnings.
- The numerator of the tier 1 capital ratio is CET1 capital plus other tier 1 capital, which consists of unsecured and paid-in capital instruments with no maturity date. For example, preferred stock issued by a bank that does not require the bank to redeem the stock on any fixed date can count toward the bank’s other tier 1 capital.
- The numerator of the total capital ratio is the sum of CET1 capital, other tier 1 capital, and tier 2 capital. Tier 2 capital consists of unsecured and paid in capital instruments subordinated to depositors with a minimum maturity of five years.<sup>4</sup> For example, if a bank issues debt that is junior to the rights of the bank’s depositors and that does not mature for 5 or more years, the debt counts toward the bank’s tier 2 capital.

As a simplified example, assume a bank has issued common stock worth \$40 million, perpetual noncumulative preferred stock worth \$5 million, and junior debt with a 10-year maturity worth \$5 million. The bank’s CET1 capital is \$40 million (i.e., its common stock); its other tier 1 capital is \$5 million (the preferred stock), making its total tier 1 capital \$45 million; its tier 2 capital is \$5 million (junior debt), making its total capital \$50 million.

The denominator of each risk-based capital ratio is the bank’s total risk-weighted assets (“RWA”). RWA is calculated by multiplying the value of a bank’s assets by a risk weighting percentage.

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<sup>2</sup> Certain smaller banks that qualify as community banks can instead elect to apply the community bank leverage ratio in place of these ratios.

<sup>3</sup> CONGRESSIONAL RESEARCH SERVICE, BANK CAPITAL REQUIREMENTS: A PRIMER AND POLICY ISSUES 11 (2023), <https://crsreports.congress.gov/product/pdf/R/R47447>.

<sup>4</sup> 12 CFT, Ch. III, Subchapter B, Part 324.20.

Riskier assets are intended to receive higher percentages. For example, assume a senior residential mortgage receives a risk weight of 50%. This means that if a bank holds such a mortgage worth \$1 million, its RWA increases by \$500,000, and it must hold an additional \$22,500 (4.5% of \$500,000) in CET1 capital. By contrast, assume an investment in a junior residential mortgage receives a risk weighting of 100%. This means that if a bank holds such a mortgage worth \$1 million, its RWA increases by \$1 million, and it must hold an additional \$45,000 in CET1 capital (4.5% of \$1 million).

For banks with \$100 billion or more in gross assets (“large banks”), the methodology for the calculation of RWA depends in part on which of four size-based categories the bank belongs to.<sup>5</sup> The categories are:

- Category I: U.S. global systemically important bank holding companies (“GSIBs”) and their depository institution subsidiaries.
- Category II: Bank holding companies with \$700 billion+ in total consolidated assets or \$75 billion+ in cross-jurisdictional activity and their depository institution subsidiaries.
- Category III: Bank holding companies with \$250 billion+ in total consolidated assets or \$75 billion+ in weighted short-term wholesale funding, nonbank assets, or off-balance sheet exposure and their depository institution subsidiaries.
- Category IV: Bank holding companies with \$100 billion+ in total consolidated assets and their depository institution subsidiaries.

#### *Standardized Approach Methodology*

Categories I through IV all calculate their RWAs according to the “standardized approach” methodology. The standardized approach requires that banks apply separate risk weighting multipliers for credit risk and market risk, except for banks with trading activities below specified minimum thresholds, which are exempt from applying market risk multipliers. The standardized approach determines risk weighting multipliers for credit risk entirely with standardized formulas; a bank’s internal risk models are irrelevant. In the case of market risk, banks are required to apply the bank’s internal models, subject to defined parameters, to calculate risk-weighted assets.

Credit risk refers to the risk that a bank’s borrower or other counterparty will fail to perform on its obligations to the bank.<sup>6</sup> Market risk refers to the risk that price movements caused by changes in market conditions and market events reduce the value of a bank’s assets.<sup>7</sup>

The standardized approach does not apply any multipliers for operational risk or credit valuation adjustment (“CVA”) risk, although CVA risk is reflected in the standardized measure of credit risk. Operational risk refers to the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, including legal risk.<sup>8</sup> CVA risk refers to the risk that a bank will be required to recognize a loss on a derivatives contract as a result of a reduction in the

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<sup>5</sup> CONGRESSIONAL RESEARCH SERVICE, *supra* note 3 at 14-25.

<sup>6</sup> Proposal at 64,082.

<sup>7</sup> *Id.* at 64,901.

<sup>8</sup> *Id.* at 64,082.



derivative counterparty’s creditworthiness.<sup>9</sup> As a result, banks are not required to hold capital against operational risk, or to separately calculate CVA risk, as part of the standardized approach.

*Advanced Approaches Methodology*

Category I and II banks (the largest banks) are also required, in addition to applying the standardized methodology, to calculate their RWAs using the “advanced approaches” methodology. The advanced approaches methodology includes risk weighting multipliers for credit and market risk and, unlike the standardized approach, for operational risk and CVA risk as well. Importantly, the advanced approaches methodology also allows banks to use internal models to calculate risk weightings for each of the credit, market, CVA, and operational risk calculations.

Category I and Category II banks must hold enough capital to satisfy the more restrictive of the advanced approaches and standardized approach. For example, if an advanced approaches bank would have a 4% CET1 ratio using the standardized approach and a 5% CET1 ratio using the advanced approaches, the bank’s CET1 ratio is determined by the standardized approach and is 4%, so the bank must raise additional CET1 capital to meet the minimum CET1 ratio of 4.5%.

*B. Minimum capital buffers*

In addition to the minimum risk-based capital ratios, banks with more than \$100 billion in assets must maintain a capital conservation buffer (“CCB”) consisting of additional CET1 capital on top of the minimum CET1 capital ratio or be subject to restrictions on corporate distributions and executive compensation. Because banks practically always seek to avoid these restrictions, the CCB is effectively a mandatory increase to a bank’s minimum CET1 ratio.

As with the minimum ratios, there are both standardized and advanced approaches to calculating the CCB. If a bank’s minimum CET1 ratio is determined by the standardized approach, then the bank’s CCB is determined by the standardized CCB calculation. If a bank’s minimum CET1 ratio is determined by the advanced approaches, then the bank’s CCB is determined using the advanced approaches.

All large banks’ CCBs are equal to the sum of (1) a stress capital buffer (“SCB”) of at least 2.5% of total RWA, (2) any applicable countercyclical capital buffer (“CCyB”) of up to 2.5% of total RWA, and (3) in the case of GSIBs, a GSIB surcharge of between 1% and 4.5% of total RWA.

Under the standardized approach, the SCB is subject to a minimum 2.5% floor and an additional buffer determined by the results of the Fed’s annual stress tests. Under the advanced approach, the SCB is a fixed charge of 2.5%.

Currently there is no CCyB in effect.

The GSIB surcharge is calculated according to formulas that are intended to reflect the GSIB’s systemic importance to the financial system. The GSIB surcharge calculation is the same whether the bank applies the standardized or advanced approach.

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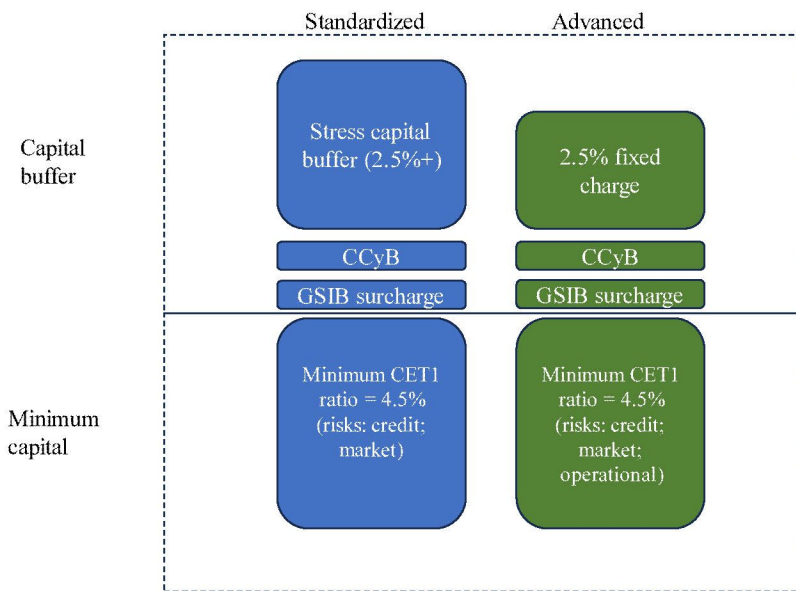
<sup>9</sup> *Id.* at 64,150.

*Minimum Capital Requirements + Buffers; The Standardized Approach is Typically Binding*

The standardized approach, even though it does not include a charge for operational risk in the calculation of the minimum CET1 ratio, generally requires more overall CET1 capital than the advanced approach and is thus more commonly binding on large banks.

This “dual stack” approach is illustrated in Figure 1. The figure shows a simplified example of the minimum CET1 capital and capital buffer requirements for a standardized and advanced approaches bank.

Figure 1: The “Dual Stack” Approach



C. Minimum leverage ratios

All large banks must also maintain a minimum leverage ratio of 4%. The numerator of the leverage ratio is tier 1 capital, and the denominator is a bank’s assets, unadjusted by any risk weightings.

Banks in Categories I, II, and III are also subject to a supplementary leverage ratio (“SLR”). The numerator of the SLR is also tier 1 capital, but the denominator includes certain off-balance sheet exposures, and is thus larger than the leverage ratio’s denominator. The SLR is 3% for banks in Categories II and III. For banks in Category I (i.e., G-SIBs), the bank must maintain an SLR of 5% at the holding company level and 6% at the depository institution level.

These leverage ratios apply separately from the risk-based capital ratios and capital buffers described above.

**2. How the Proposal would change the calculation of large banks’ capital requirements**

The Proposal would change the rules described above for all banks with over \$100 billion in assets (Category I-IV banks). We describe here certain aspects of the Proposal’s reforms.

*A. Creation of a new risk-based capital approach*

The Proposal would create a new methodology for the calculation of RWA (the “expanded risk-based approach”) and require all large banks to calculate minimum capital under the existing standardized approach and the new expanded risk-based approach. The Proposal would eliminate the advanced approaches methodology. Unlike the advanced approaches methodology, which it replaces, this new methodology does **not** permit the use of internal models except in limited cases for market risk, as explained below.

All large banks would be required to calculate their risk-based capital using the more restrictive of the standardized approach and the new expanded risk-based approach.<sup>10</sup> In general, the expanded risk-based approach is expected to require more capital than the existing standardized approach and as a result will be the binding risk-based capital requirement for large banks going forward.<sup>11</sup>

Under the expanded risk-based approach, a bank’s total RWA would be equal to the sum of its operational risk RWA, market risk RWA, CVA risk RWA, and credit risk RWA.

**Operational Risk:** The expanded risk-based approach would include a charge for operational risk, unlike the standardized approach, which does not include a charge for operational risk. A bank’s operational RWA would be determined by multiplying the bank’s “business indicator component” (“BIC”) by the bank’s “internal loss multiplier” (“ILM”).

The BIC is intended to “serve as a proxy for a [bank’s] business volume”<sup>12</sup> by measuring income from interest, leases, dividends, fee income, and other operational income. Notably, (1) the extent to which a bank’s BIC could be increased by interest income from lending is capped, but there is no equivalent cap for fee-based income, such as fees from a bank’s provision of credit card, custody, or advisory services, and (2) banks would be permitted to reduce interest income by expenses related to the production of that income but would not be permitted to reduce fee-related income by associated expenses.

A bank’s ILM is intended to measure a bank’s historical operational losses.<sup>13</sup> It is determined by the ratio of the bank’s average annual total net operating losses over the prior 10 years to its BIC and a complex logarithmic calculation.<sup>14</sup> If a bank’s operating losses are higher relative to its operating income as measured by its BIC, its ILM will tend to be higher. For example, if a bank’s average annual net operating loss was \$10 million and its BIC is \$100 million, then its ILM will be approximately 1.38 as determined by the ratio and the logarithmic calculation. This is higher

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<sup>10</sup> *Id.* at 13-14.

<sup>11</sup> SIFMA, *Understanding the Proposed Changes to the US Capital Framework* (Aug. 28, 2023), [https://www.sifma.org/resources/news/understanding-the-proposed-changes-to-the-us-capital-framework/#\\_ftn3](https://www.sifma.org/resources/news/understanding-the-proposed-changes-to-the-us-capital-framework/#_ftn3).

<sup>12</sup> Proposal, at 64,083.

<sup>13</sup> *Id.* at 64,086.

<sup>14</sup> *Id.*



than a bank with the same \$10 million average annual net operating losses and a BIC of \$200 million. This bank would have an ILM of 1.13, as determined by the ratio and the logarithmic calculation.

If an ILM is below 1 because historical losses due to operational risk are low, then multiplying the ILM by the BIC would reduce the minimum operational capital requirements. Conversely, if the ILM is above 1 because historical losses due to operational risk are relatively higher, then multiplying the ILM by the BIC would increase the minimum operational risk capital requirement.

Critically, under Basel III, the ILM can either reduce or increase the bank's operational risk capital requirements. However, the Proposal applies a floor to the ILM of 1 such that it can only increase a bank's operational risk capital and not reduce it. Therefore, under the Proposal, a bank can only be penalized for having high historical losses and does not receive credit for having low historical losses.

**Market Risk:** The expanded risk-based approach would impose greater restrictions on the use of internal models to calculate risk weights for market risk. More specifically, whereas banks are currently permitted to apply internal models to calculate market risk for all of its assets, under the Proposal's approach, a bank would be permitted to use internal models only with respect to those specific asset classes approved by the bank's primary federal supervisor.<sup>15</sup>

The methodologies for calculating market risk would also now be determined according to a set of Basel principles known as the "Fundamental Review of Trading Book" ("FRTB"). The FRTB would, among other things (i) remove the exemption that currently allows banks with only limited trading activity to avoid incurring capital charges for market risk, (ii) expand the definition of a bank's trading book (i.e., the set of assets subject to market risk), (iii) prohibit a bank from reducing its capital requirements by transferring assets from its trading book to its banking book, and (iv) change the formulas for the calculation of market risks to capture additional tail risks. These modifications, including the restrictions on the use of internal models, are expected to result in an aggregate increase in capital required to cover market risks of 60% across all banks subject to the Proposal.<sup>16</sup>

Consistent with Basel III, the Proposal would also establish an "output floor" that would limit the extent to which the use of internal models for market risk could reduce a bank's capital requirements under the new expanded risk-based approach. The output floor would be equal to 72.5% of what the bank's total RWA would be if it did not apply internal models to market risk. For example, if the bank's total RWA applying internal models to market risk would be \$70 billion, but its total RWA without applying those internal models to market risk would be \$100 billion, the bank's total RWA under the expanded risk-based approach is \$72.5 billion (since \$70 billion is less than 72.5% of what the bank's total RWA would be if it does not use internal models for market risk).

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<sup>15</sup> *Id.* at 16.

<sup>16</sup> Greg Hopper, BANK POLICY INSTITUTE, *How Can the New Market Risk Capital Requirements Be Fixed?* (Sept. 25, 2023), <https://bpi.com/how-can-the-new-market-risk-capital-requirements-be-fixed/>.

**Credit Risk:** The calculation of credit risk would be modified substantially. Although the Agencies do not expect these changes to increase capital required with respect to credit risk in the aggregate across all banks subject to the Proposal,<sup>17</sup> the capital required with respect to specific banks and categories of lending, such as credit card lending, would increase. Certain of the key reforms to credit risk under the expanded risk-based approach methodology would be:

- Modified Risk Weighting Criteria: Consistent with Basel III, the Proposal would incorporate additional criteria for determining the credit risk weights that apply to a bank's loan assets. For example, the risk weighting applied to a mortgage loan would consider cash flow from the property and the creditworthiness of the underlying borrower, which are not currently considered. As a result, the Proposal could require certain assets to be assigned a higher risk weighting.
- Gold Plating: The Proposal would revise the credit risk weights that apply to certain bank loan assets. Importantly, the Proposal's credit risk weights are generally 10 to 20 percentage points higher than those prescribed under Basel III (i.e., "gold plating"). For example, the risk weighting percentages for residential mortgage loans under Basel III vary from 20% to 105%. Under the Proposal they vary from 40% to 125%. The risk weighting percentage for a revolving line of credit under Basel III is 75%; under the Proposal it is 85%. According to the Agencies' estimate, this gold plating is not expected to increase aggregate capital required for credit risk, because some of the new risk weights, even with gold plating, are lower than existing risk weights under the standardized approach.
- Corporate Debt: Consistent with Basel III, the expanded risk-based approach would allow for a reduced 65% risk weighting for a bank's exposure to investment grade corporate debt, but only if the exposure is to a company that has public securities outstanding. If the company is not public, a 100% risk weight applies. Presently, banks are subject to a 100% risk-weight for all such corporate debt exposures. As discussed further in Part II, this approach significantly disfavors lending to operating businesses and investment vehicles, particularly mutual funds and pension funds, that do not have exchange-listed shares.
- Undrawn Commitments: Consistent with Basel III, there would be a 10% credit risk charge for undrawn commitments (i.e., amounts that a bank has committed to loan to a borrower, but that the borrower has not yet actually borrowed). No such charge presently exists. This change would therefore significantly increase the amount of capital required for credit card lending.

**CVA Risk:** The expanded risk-based approach would include separate multipliers for CVA risk, unlike the current standardized approach, which does not include separate multipliers for CVA risk but instead incorporates CVA risk into credit risk.

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<sup>17</sup> Proposal at 64,168.



*B. Expanding requirements for Category III and IV banks*

The Proposal would require Category III and IV banks to apply several of the more stringent capital requirements that currently apply only to Category I and Category II banks, each of which is expected to require them to carry additional capital:

- Imposing higher deductions to CET1 capital for mortgage servicing assets and deferred tax assets:** Category III and IV banks are currently subject to the simplified capital deduction framework adopted in 2019 as part of the Agencies’ capital simplification rule.<sup>18</sup> Under the simplified framework, Category III and IV banks are required to reduce their CET1 capital (the numerator in the CET1 capital ratio) by the amount by which their exposure to mortgage servicing assets (“MSAs”), deferred tax assets (“DTAs”), and investments in financial institutions individually exceeds 25% of their CET1 capital. The Agencies impose these deductions because they consider these assets to be harder for banks to accurately value, and inherently riskier.<sup>19</sup>

For example, if a bank has \$10 billion in common stock it would typically have \$10 billion in CET1 capital. However, if the bank holds \$2.8 billion in MSAs, \$500 million in DTAs, and \$500 million in investments in financial institutions, then the bank’s individual exposure to MSAs (\$2.8 billion or 28% of \$10 billion in CET1 capital) exceeds 25% of CET1 capital by \$300 million. Therefore, the bank’s CET1 capital is reduced to \$9.7 billion. The bank’s individual exposures to DTAs and investments in financial institutions remain below the 25% limit so no further deductions are required.

The Proposal would apply a more complex and restrictive standard and require banks to reduce their capital when (a) their individual exposure to MSAs, DTAs, or certain investments in unconsolidated financial institutions exceeds 10% of CET1 capital, and (ii) their aggregate exposure to those assets exceeds 15% of CET1 capital, in each case, consistent with what currently applies to Category I and Category II banks. In the example above, the bank’s individual exposure to MSAs (\$2.8 billion) exceeds 10% of CET1 capital (i.e., \$1 billion) by \$1.8 billion. Therefore, the bank’s CET1 capital would be reduced from \$10 billion to \$8.2 billion. In addition, the combined amount of MSAs, DTAs, and investments in financial institutions not deducted under the 10% individual limit would also need to be deducted if they, on a combined basis, exceed the 15% aggregate limit. In this example, the combined amount of MSAs, DTAs, and investments in financial institutions not deducted under the 10% individual limit equals \$2 billion and exceeds the 15% aggregate limit by \$500 million. As a result, the bank’s CET1 capital would be further reduced to \$7.7 billion.

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<sup>18</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; FEDERAL DEPOSIT INSURANCE CORPORATION, *Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*, 84 FED. REG. 35,234 (July 22, 2019).

<sup>19</sup> Proposal at 64,036.



As discussed in Part II below, these changes will disincentivize Category III and IV banks from engaging in mortgage servicing activities and will also have a disproportionate adverse effect on consumer lending banks.

- **Including AOCI in regulatory capital for all large banks.** Category III and IV banks can currently elect to exclude accumulated other comprehensive income (“AOCI”) from their calculation of regulatory capital. Most importantly, AOCI measures changes to the market value of “available for sale” securities, which are securities that a bank may potentially sell before maturity. Thus, for banks that have made this election, reductions to the value of AFS securities do not decrease a bank’s capital for purposes of complying with minimum capital requirements and increases to the value of AFS securities do not increase a bank’s capital for purposes of complying with minimum capital requirements. The Proposal would remove this exemption and require Category III and IV banks to include AOCI in the calculation of a bank’s capital for purposes of complying with their minimum capital requirements.
- **Expansion of supplementary leverage ratio (SLR):** The Proposal would require Category IV banks to adhere to the SLR, which currently only applies only to banks in Categories I, II, and III.
- **Mandatory application of SA-CCR to calculate derivatives exposure:** The Proposal would require Category III and IV banks to apply the “standardized approach for counterparty credit risk” (“SA-CCR”) to calculate their derivatives exposures for purposes of calculating their risk-based capital and leverage ratios.<sup>20</sup> Currently, Category III and IV banks are permitted to choose between applying SA-CCR and the alternative “current exposure methodology.” The SA-CCR methodology generally results in higher exposure amounts and will therefore likely increase the calculation of the bank’s RWA and total assets, and thus will likely require Category III and IV banks to carry more capital with respect to their derivatives exposures.

*C. Minimum haircut floors for certain securities-financing transactions*

Banks generally are entitled to apply lower risk weightings to their securities-financing transactions (“SFTs”) to the extent the bank receives collateral from its counterparty. Under the Proposal’s “minimum haircut floor” provisions, in the case of certain repo-style and margin loan SFTs with “unregulated financial institutions,” no portion of the bank’s position would be considered collateralized unless the bank “haircuts” (i.e., discounts) the value of the fair value of the collateral by at least a specified percentage.<sup>21</sup>

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<sup>20</sup> *Id.* at 64,033.

<sup>21</sup> *Id.* at 64,063.

The amount of the minimum haircut depends on the type of security provided as collateral. For example, in the case of main index equities, the minimum haircut is 6%,<sup>22</sup> meaning that if the counterparty is obliged to deliver \$100 in cash to the bank at the conclusion of the transaction, the bank must receive at least \$106.32 (i.e.,  $\$100/(1-.06)$ ) in equity security collateral. If the collateral received is less than this value, the position is considered fully uncollateralized, and the bank must therefore apply a higher risk weighting to that position.

Among other exceptions, the Proposal provides that there is no minimum haircut for collateral consisting of Treasury or other non-defaulted sovereign debt or if the bank enters into the SFT for the purpose of obtaining securities to meet customer demand and not to provide financing to the counterparty.<sup>23</sup>

*D. Aggregate effects on bank capital.*

As the Proposal acknowledges, the modifications that it contemplates would materially increase capital requirements in the aggregate for large U.S. banks.

More specifically, across all banking organizations subject to the Proposal, the Agencies estimate that the amount of required CET1 capital will increase on average by 16%.<sup>24</sup> For Category I and II banks (i.e., the largest banks) specifically, the estimated increase is 19%.<sup>25</sup> For domestic Category III and IV banks, the estimated increase is 6%.<sup>26</sup> For foreign Category III and IV banks, the estimated increase is 14%.<sup>27</sup> There are no foreign Category I or Category II banks.

The capital increases for banks that focus their businesses on supporting capital markets and providing valuable services such as custody protections for customer assets – both important components of the U.S. banking sector – are likely to be particularly severe. However, the Proposal does not calculate the impact on capital requirements for banks focused on such activities. According to one estimate, the amount of capital that banks will be required to hold to cover market risk will increase by 60% over current requirements for all banks subject to the Proposal and 70% for the largest banks.<sup>28</sup>

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<sup>22</sup> *Id.* at 64,065.

<sup>23</sup> *Id.* at 64,064.

<sup>24</sup> *Id.* at 64,169.

<sup>25</sup> *Id.* at Note 465.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

<sup>28</sup> Hopper, *supra* note 16; Testimony of Greg Baer, President and CEO, Bank Policy Institute 14 (Sept. 14, 2023), <https://docs.house.gov/meetings/BA/BA20/20230914/116339/HHRG-118-BA20-Wstate-BaerG-20230914.pdf>.

## II. ANALYSIS OF THE PROPOSAL

In this Part II we assess the Proposal's reforms. We first examine the "Impact and Economic Analysis" (the "IEA") that the Proposal presents in support of the Proposal's capital increases and find that it fails to support its conclusion that the Proposal's benefits will outweigh its costs. We then examine the relevant empirical evidence and find that, to the contrary, the Proposal's costs are likely to outweigh its benefits. More specifically, the Proposal is likely to reduce banks' borrowing and capital markets activities without an offsetting benefit to financial stability. In addition, the Proposal could interfere with the Fed's current contractionary monetary policies. We therefore recommend that, should the Agencies choose to finalize the Proposal, then the implementation date should be delayed until economic conditions are more stable.

We then identify issues with specific aspects of the Proposal and make recommendations for how the Agencies can mitigate these issues and the overall economic costs of the Proposal, including by rolling back gold plating and eliminating aspects of the Proposal that implement features of Basel III that duplicate other preexisting U.S.-specific requirements, such as the SCB, and are therefore unduly burdensome.

### **1. The Proposal's Impact and Economic Analysis is fundamentally flawed.**

According to the Proposal's IEA, increasing bank capital will strengthen the resiliency of the U.S. financial system and these benefits will outweigh the economic costs of requiring banks to carry more capital, such as reduced lending.<sup>29</sup> However, the IEA that purports to support this rationale occupies only 5 of the Proposal's total 316 pages, or 1.6% of the Proposal's total length. This starkly brief analysis is wholly inadequate to justify the conclusion that the Proposal's benefits will outweigh its costs, for three principal reasons.

First, the IEA's estimates of the Proposal's effects on bank capital are based on outdated and incomplete data. The IEA thus lacks a reliable basis on which to estimate the actual costs and benefits of the Proposal. Second, the IEA fails to substantiate or quantify the Proposal's purported financial stability benefits or to consider the substantial evidence that bank capital levels are high enough. And third, the IEA fails to fully consider the extensive empirical evidence that the Proposal's increases to bank capital could slow economic growth by reducing banks' lending and capital markets activities. Indeed, the IEA fails entirely to attempt to estimate these potential costs and also ignores other costs of the Proposal, particularly the potential for an increase in capital to interfere with the Fed's monetary policy and the potential negative effects for specific sectors of borrowing markets, particularly retail and small business borrowers. The IEA also fails to consider the potential for the Proposal's higher capital requirements to cause lending and capital markets

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<sup>29</sup> *Id.* at 64,167; *see also* Board of Governors of the Federal Reserve System, Statement by Vice Chair for Supervision Michael S. Barr (Jul. 27, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20230727.htm>.



activities to migrate from banks to non-bank financial institutions – a process referred to as “disintermediation” – and the costs stemming therefrom.<sup>30</sup>

*A. The IEA is based on unreliable estimates of the Proposal’s effects.*

The IEA bases its estimates of the Proposal’s effects on bank capital on the Basel Committee’s Quantitative Impact Study (the “QIS”). The QIS sought to estimate the effect of Basel III Finalization on the capital requirements of a sample of banks from various jurisdictions that submitted data to the Basel Committee for the purpose of the study.<sup>31</sup> The Agencies rely on data submitted by U.S. banks for purposes of their estimates. For U.S. banks that did not participate in the QIS, the economic analysis relies on regulatory financial reports that these banks filed with U.S. banking agencies – specifically the Call Report, FR Y-9C, FR Y-14, FFIEC 101 – for the year ended 2021.<sup>32</sup>

Estimating the Proposal’s effects using these sources is flawed for several reasons. First, as the Proposal acknowledges, the QIS was “based on banking organizations’ assumptions on how the Basel III reforms would be implemented in the United States.” As detailed in Part I, the Proposal departs from Basel III reforms in several significant respects, such that the impact of Basel III on a bank will likely diverge significantly from the impact of the Proposal. As only one prominent example, the Proposal imposes higher risk weights for credit risk than those that Basel III prescribes.

Second, as the IEA notes, the regulatory filings that it relies on to estimate effects for banks that did not participate in the QIS were, as in the case of the QIS data, also two years out of date and thus “do not account for potential changes” in banks’ “structure,” “behavior,” or “market conditions” since that time.<sup>33</sup> Moreover, as the IEA also notes, these filings do not contain sufficient information to allow for “precise estimates.”<sup>34</sup> The IEA must therefore make “projections” about the assets and activities of these non-participant banks based on information submitted by banks that did participate in the QIS. The resulting estimates thus fail to reflect unique features of U.S. banks that did not participate in the QIS.

*B. The IEA fails to quantify or substantiate the Proposal’s purported benefits.*

The IEA asserts that by increasing capital requirements, the Proposal will increase the “resiliency of the financial system.”<sup>35</sup> The IEA supports this claimed benefit with a string of citations to academic literature that examines the effects of bank capital requirements on financial stability

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<sup>30</sup> Testimony of Greg Baer, *supra* note 28 at 5-6; Herbert L. Baer & Janet Napoli, FEDERAL RESERVE BANK OF CHICAGO, *Disintermediation Marches On*, Chicago Fed Letter No. 41 (Jan. 1991), <https://www.chicagofed.org/publications/chicago-fed-letter/1991/january-41>.

<sup>31</sup> BASEL COMMITTEE ON BANKING SUPERVISION, *Basel III Monitoring Report* (Dec. 2017), <https://www.bis.org/bcbs/publ/d426.pdf>.

<sup>32</sup> Proposal at 64,167.

<sup>33</sup> *Id.* at 64,168.

<sup>34</sup> *Id.*

<sup>35</sup> *Id.* at 64,167.

and economic activity. The IEA claims that “current capital requirements in the United States are toward the low end of the range of optimal capital levels described in [this] literature.”<sup>36</sup>

This evidence is, however, inadequate to support the IEA’s conclusion that the Proposal will enhance the stability of the U.S. financial system. Most basically, the IEA does not present a rationale for increasing capital if it is already within an optimal range. And even if current capital levels are within a range that some empirical literature identified as optimal, it does not follow that increasing capital requirements within that range will produce marginal benefits to financial stability and the IEA’s analysis adds nothing to show that it will.

More specifically, the IEA’s analysis consists solely of general citations to literature examining data from different time periods and jurisdictions. It does not cite any findings in these papers or identify any aspects of current capital levels that would indicate that increasing capital under current conditions would increase financial stability. In addition, the IEA makes no attempt to quantify, or to describe qualitatively, the financial stability benefits that it expects will result from the Proposal’s capital increases.

In fact, the findings of several of the papers the IEA cites provide no support for the assertion that the Proposal’s capital increases will have net benefits, and in some cases in fact undermine this assertion. For example, in Dagher et al. (2016) the authors note that “estimating the optimal level of bank capital is likely an impossible task ex ante” and that such an analysis could not provide “convincing policy guidance.”<sup>37</sup> Their analysis is therefore focused on determining the amount of capital that banks needed to withstand past crises. They also note that from a regulatory standpoint, capital requirements may be set below any theoretically optimal range, because banks “tend to hold capital in excess of regulatory minima, and other bail-in-able instruments can contribute to loss absorption capacity.”<sup>38</sup> Firestone et al. (2019) finds that at levels above 13% tier 1 capital, the probability that further capital increases will produce negative net effects begins to increase, while the probability that such increases will produce net positive effects decreases steadily.<sup>39</sup> U.S. banks’ current aggregate tier 1 capital is over 16%<sup>40</sup> and is thus already well above the threshold where the probability of net negative effects from further increases steadily grows. The study therefore suggests that by increasing capital further, the Proposal would increase the likelihood of net negative effects.

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<sup>36</sup> *Id.* at 64,169.

<sup>37</sup> Jihad Dagher, et al., *Benefits and Costs of Bank Capital* IMF Staff Discussion Notes No. 2016/004 11 (2016), <https://www.imf.org/en/Publications/Staff-Discussion-Notes/Issues/2016/12/31/Benefits-and-Costs-of-Bank-Capital-43710>.

<sup>38</sup> *Id.* at 4.

<sup>39</sup> Simon Firestone et al., *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the United States* Vol. 101 No. 3, 204 (2019), <https://research.stlouisfed.org/publications/review/2019/07/12/an-empirical-economic-assessment-of-the-costs-and-benefits-of-bank-capital-in-the-united-states>.

<sup>40</sup> FEDERAL RESERVE BANK OF NEW YORK, *Quarterly Trends for Consolidated U.S. Banking Organizations*, Q3 2023, [https://www.newyorkfed.org/research/banking\\_research/quarterly\\_trends](https://www.newyorkfed.org/research/banking_research/quarterly_trends).



Another study that the IEA cites, Begenau & Landvoigt (2022), suggests that the optimal capital level for U.S. banks is higher than current levels.<sup>41</sup> But that study fails to take into account several important factors. For example, the analysis assumes that banks exclusively hold risky assets when in fact Basel III liquidity rules require banks to devote a significant percentage of their portfolios to highly liquid assets such as Treasury securities. The analysis also assumes that all bank liabilities consist of insured deposits, when in fact a significant percentage of bank liabilities consist of long-term debt convertible to equity and only approximately half of bank deposits are insured. These inaccurate assumptions result in an overestimation of the likelihood and costs of bank failures, and thus an overestimation of optimal capital levels.

There is also empirical evidence, which the IEA does not consider, indicating that any estimate of the effects of increasing bank capital are subject to considerable imprecision under any circumstances and become less precise as bank capital increases above current regulatory requirements. De Ramon (2012), for example, found that estimating the economic effects of increasing capital requirements is subject to significant uncertainty and that there is decreasing statistical confidence that net benefits are positive for capital levels beyond current Basel III standards.<sup>42</sup>

There is also substantial evidence, which the IEA also fails to consider, that U.S. bank capital levels are already strong, which further calls into question whether the Proposal will produce any marginal benefits for financial stability.

In particular, U.S. bank capital levels are at their highest levels since the 2008 financial crisis. As the New York Fed reported in its most recent quarterly report, U.S. bank capital is “high by historical standards” and “well above” its pre-2008 crisis levels.<sup>43</sup> In particular, the average CET1 capital ratio of U.S. banking organizations for the 2001-2007 period was 8.25%.<sup>44</sup> As of Q3 2023, it had increased by over four percentage points to 13.12%.<sup>45</sup>

Thus, despite the Proposal’s contention that current U.S. bank capital levels are toward the lower end of the optimal range established in the academic literature, current CET1 capital for all U.S. bank holding companies (13.12%) is in fact 1.32% above the midpoint of the range suggested by the studies the Proposal relies on (11.8%). Moreover, this estimated midpoint incorporates the findings of studies that rely on less rigorous methods and that were not published in peer-reviewed journals.<sup>46</sup> The midpoint suggested by only the most recent and rigorous empirical research

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<sup>41</sup> Juliane Begenau & Tim Landvoigt, *Financial Regulation in a Quantitative Model of the Modern Banking System* 89(4) THE REVIEW OF ECONOMIC STUDIES 1748 (2022), <https://academic.oup.com/restud/article-abstract/89/4/1748/6482752>

<sup>42</sup> Sebastian de-Ramon et al., *Measuring the Impact of Prudential Policy on the Macroeconomy: A Practical Application to Basel III and Other Responses to the Financial Crisis*, FSA Occasional Paper No. 42 (2012), <https://ideas.repec.org/p/pram/prapa/69423.html>.

<sup>43</sup> FEDERAL RESERVE BANK OF NEW YORK, *supra* note 40.

<sup>44</sup> *Id.*

<sup>45</sup> *Id.*

<sup>46</sup> Francisco Covas & Bill Nelson, BPI, *U.S. Bank Capital Levels: Aligning with or Exceeding Midpoint Estimates of Optimal* (Sept. 18, 2023), <https://bpi.com/u-s-bank-capital-levels-aligning-with-or-exceeding-midpoint-estimates-of-optimal/>.



published in leading academic journals (e.g., Begenau (2020),<sup>47</sup> Elenev et al. (2021),<sup>48</sup> Begenau & Landvoigt (2022)<sup>49</sup>), suggests that the midpoint of the optimal range is 10.3%, which puts current U.S. bank capital even higher (2.82%) above the midpoint.

Furthermore, bank capital was not strained by the severe market turmoil that occurred in March 2020 as a result of the COVID-19 pandemic. Indeed, the aggregate CET1 capital ratio across U.S. banks declined by only 15 basis points over the course of 2020, from 12.25% as of year-end 2019 to its lowest point in 2020 of 12.10%, before climbing back to its current level.<sup>50</sup>

The IEA does not consider this significant countervailing evidence.

*C. The IEA fails to consider or quantify all of the Proposal's potential costs.*

There is extensive empirical evidence indicating that the Proposal's increases to bank capital requirements could impose significant costs on the U.S. economy. The IEA acknowledges some of these costs in principle but fails to analyze them fully or attempt to quantify them. The IEA completely ignores other costs.

i. Reduced lending and higher borrowing costs.

The IEA states that the Proposal will only “modestly” increase capital requirements for lending activity. It concludes that the Proposal will therefore only result in a “slight” reduction in affected banks’ lending activities.<sup>51</sup> The Proposal therefore claims that the benefits of increased resiliency of the financial system will continue to outweigh the costs of this reduction in lending activity.<sup>52</sup>

This assessment omits significant effects of the Proposal on capital required with respect to lending activities.<sup>53</sup> In particular, it completely ignores how the Proposal will impose new operational risk charges with respect to non-interest income that is closely associated with lending activity, such as fees from the issuance of credit cards, the servicing of mortgages, and syndicated lending. According to an estimate by BPI, these operational risk charges will increase banks’ risk-weighted assets by \$1 trillion, and “nearly quadruple” the Proposal’s effect on bank lending costs relative to the Agencies’ estimates.<sup>54</sup> Also, the IEA focuses purely on the effect of the Proposal on credit risk capital in the aggregate. It does not consider how the Proposal’s changes are likely to increase the costs of specific types of lending, including lending to consumers and small businesses and mortgage loans to lower-income and first-time homebuyers, and thus incentivize banks to shift the

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<sup>47</sup> Juliane Begenau, *Capital Requirements, Risk Choice, and Liquidity Provision in a Business-Cycle Model* 136.2 JOURNAL OF FINANCIAL ECONOMICS 355 (2020), <https://www.sciencedirect.com/science/article/abs/pii/S0304405X19302508?via%3Dihub>.

<sup>48</sup> Vadim Elenev et al., *A Macroeconomic Model with Financially Constrained Producers and Intermediaries* 89(3) ECONOMETRICA (2021), <https://onlinelibrary.wiley.com/doi/abs/10.3982/ECTA16438>.

<sup>49</sup> Begenau & Landvoigt, *supra* note 41.

<sup>50</sup> FEDERAL RESERVE BANK OF NEW YORK, *supra* note 40.

<sup>51</sup> Proposal at 64,167.

<sup>52</sup> *Id.*

<sup>53</sup> Francisco Covas, BPI, *The Trillion Dollar Omission in Vice Chair Barr's Cost Analysis* (Oct. 12, 2023), <https://bpi.com/the-trillion-dollar-omission-in-vice-chair-barrs-cost-analysis/>.

<sup>54</sup> *Id.*

mix of their lending activities to favor larger and higher income borrowers. While these shifts may not affect the supply of credit in the aggregate, they will affect the ability of subcategories of borrowers to obtain credit.

The IEA also fails to consider in any detail the substantial body of empirical literature demonstrating that higher capital requirements reduce bank lending and increase the cost of borrowing, which slows economic growth. As only a handful of examples, a 2010 survey by the Bank for International Settlements (“BIS”) of modelling conducted by the International Monetary Fund, central banks, and bank regulators in 15 jurisdictions found that a 1% increase in bank capital ratios implemented over 8 years in these jurisdictions would increase borrowing costs and reduce credit supply, reducing forecasted GDP by a median 0.15%.<sup>55</sup> A 2017 Federal Reserve study similarly concluded that a 1% increase in bank capital ratios increases borrowing costs and reduces long-run U.S. GDP growth by 0.074%. De-Ramon (2016) concluded that a 1% increase in bank capital requirements in the United Kingdom lowered annual loan growth by 0.12%. Acharya et al. (2017) found that the implementation of Dodd Frank bank capital stress testing in 2009 increased U.S. bank loan spreads by 0.48% and reduced credit supply. Finally, a 2016 BIS literature review summarizes: “Overall, the empirical evidence reported in the literature suggests that an increase in capital requirements by one percentage point forces banks to cut their lending in the long run by 1.4–3.5% or reduce credit growth by 1.2– 4.6%.”<sup>56</sup>

The costs from reduced lending activity due to higher capital requirements can fall disproportionately in specific economic sectors, particularly smaller banks, small businesses, and retail consumers. For example, Greene & Lux (2015) found that higher capital requirements resulted in lower levels of lending by U.S. banks, particularly loans to small businesses.<sup>57</sup> Acharya et al. (2017) found that the reduction in bank lending stemming from Dodd Frank stress testing was particularly pronounced for credit card and small business borrowers.<sup>58</sup> The Proposal’s increased risk weights for consumer credit exposures are thus likely to have a particularly significant impact on lending activity.

ii. Reductions to capital markets activities.

In the United States capital markets activities have a larger role in financing businesses than bank lending: In 2022, capital markets generated 77.5% of debt funding for nonfinancial corporations

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<sup>55</sup> BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements* 3 (2010), <https://www.bis.org/publ/othp12.pdf>.

<sup>56</sup> BASEL COMMITTEE ON BANKING SUPERVISION, BANK FOR INTERNATIONAL SETTLEMENTS, *Literature Review on Integration of Regulatory Capital and Liquidity Instruments* 7 (2016), <https://www.bis.org/bcbs/publ/wp30.pdf>.

<sup>57</sup> Marshall Lux & Robert Greene, *The State and Fate of Community Banking* (2020), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2913096](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2913096)

<sup>58</sup> Viral V. Acharya et al., *Lending Implications of U.S Bank Stress Tests: Costs or Benefits?* JOURNAL OF FINANCIAL INTERMEDIATION (2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2972919](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2972919).



in the United States.<sup>59</sup> As such, relatively small reductions in capital markets activities could have major costs for the U.S. economy.

While the IEA acknowledges that the Proposal will “substantially” increase capital requirements for trading activities and that this increase “could also increase banking organizations’ costs of engaging in market making activities”<sup>60</sup> it asserts that the “overall effect of higher capital requirements on market making activity and market liquidity remains a research question needing further study.”<sup>61</sup>

However, the IEA ignores the extensive evidence attesting to the negative effect of raising capital requirements on banks’ capital markets activities. For example, Baker et al. (2017) found that CET1 capital requirements imposed greater constraints on the activities of banks with a capital markets focus compared to traditional banks, requiring capital markets banks to continuously build more CET1 capital in the post-2008 period.<sup>62</sup> Cimon & Garriott (2019) found that Basel III caused bank affiliated dealers to change their market making business models by holding fewer positions on their balance sheets and increasingly operating on an agency basis, which reduced investor welfare.<sup>63</sup> Liang & Parkinson (2020) further observed that elements of the methodology for the calculation of the capital surcharge for global-systemically important banks “may be unnecessarily restraining market-making by bank-affiliated dealers in times of market stress.”<sup>64</sup> Wang & Zhong (2019) also found that higher capital requirements under Basel III led to an overall decrease in market making by banks.<sup>65</sup> And a 2014 BIS study observed that, following the implementation of Basel III, bank market-makers increased their focus on activities requiring less capital and balance sheet capacity and that banks in many jurisdictions allocated less capital to their market-making activities and reduced their holdings of less liquid assets.<sup>66</sup> The IEA does not consider any of this evidence.

### iii. Disintermediation

By increasing the capital costs associated with banks’ extension of credit and participation in capital markets activities, the Proposal is also likely to accelerate the migration of these activities to non-bank financial institutions, which are not subject to the same cost burdens.<sup>67</sup> This process

<sup>59</sup> SIFMA, 2022 CAPITAL MARKETS FACT BOOK 6 (2022), <https://www.sifma.org/wp-content/uploads/2022/07/CMFact-Book-2022-SIFMA.pdf>.

<sup>60</sup> Proposal at 64,167

<sup>61</sup> *Id.*

<sup>62</sup> Colleen Baker et al., *The Impacts of Financial Regulations: Solvency and Liquidity in the Post-Crisis Period*, FRB of Philadelphia Working Paper No. 17-10 (2017), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2958121](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2958121).

<sup>63</sup> David A. Cimon & Corey Garriott, *Banking Regulation and Market Making* (2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2882594](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2882594).

<sup>64</sup> Nellie Liang & Pat Parkinson, *Enhancing Liquidity of the U.S. Treasury Market Under Stress*, Hutchins Center Working Paper No. 72, 3 (2020), [https://www.brookings.edu/wp-content/uploads/2020/12/WP72\\_LiangParkinson.pdf](https://www.brookings.edu/wp-content/uploads/2020/12/WP72_LiangParkinson.pdf).

<sup>65</sup> Xinjie Wang & Zhaodong Zhong, *Post-Crisis Regulations, Market Making, and Liquidity in Over-the-Counter Markets* (2019), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3318671](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3318671).

<sup>66</sup> BANK FOR INTERNATIONAL SETTLEMENTS, COMMITTEE ON THE GLOBAL FINANCIAL SYSTEM, *Market-Making and Proprietary Trading: Industry Trends* (2014), <https://www.bis.org/publ/cgfs52.pdf>.

<sup>67</sup> Baer, *supra* note 28.



is referred to as “disintermediation.” As the Committee has previously noted, disintermediation shifts these important functions, including mortgage origination and commercial lending, to less regulated corners of the market.<sup>68</sup> The IEA fails to consider these risks.

iv. Interference with monetary policy

The IEA also fails to consider the potential for the Proposal to interfere with the Fed’s current monetary policy goals and the resulting costs. Although higher capital requirements work in the same direction as contractionary monetary policy by reducing bank lending and capital markets activity, the magnitude of the impact of increases to bank capital requirements on bank lending and capital markets activity is uncertain and difficult to adjust on a continuous basis. Moreover, once the current contractionary monetary policy cycle ceases, higher bank capital requirements could make it more difficult to restore lost financing activity with lower interest rates. For example, Markovic (2006) finds that the interaction of monetary policy and capital requirements is “asymmetric” such that higher interest rates increase the constraining effect of capital requirements on bank lending, whereas lower interest rates do not produce an offsetting effect.<sup>69</sup> Similarly, Kishan & Opiela (2006),<sup>70</sup> Bolton & Freixas (2006),<sup>71</sup> and Chami & Cosimano (2001)<sup>72</sup> find that higher bank capital requirements increase the negative effect of contractionary monetary policy on loan growth while decreasing the effectiveness of expansionary monetary policy in stimulating loan growth.

The IEA does not consider any of this evidence.

The potential for the Proposal to interfere with current monetary policy exists even though the Proposal would not begin to come into effect until July 1, 2025. This is because banks generally seek to maintain buffers above anticipated regulatory minimums and respond to future increases to bank capital requirements when they are announced, immediately increasing capital even before the implementation date of those reforms. For example, Rios-Rull et al. (2023)<sup>73</sup> and Dagher et al. (2016)<sup>74</sup> document, respectively, how banks tend to maintain capital in excess of regulatory minimums and adjust to impending increases by immediately increasing their capital levels even before the effectiveness of the requirement. The Proposal can thus be expected to slow the

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<sup>68</sup> COMMITTEE ON CAPITAL MARKETS REGULATION, BASEL FINALIZATION AND U.S. BANK CAPITAL REQUIREMENTS 4 (2023), <https://capmktsreg.org/wp-content/uploads/2023/05/CCMR-Statement-on-Bank-Capital-Basel-Finalization-05.01.23.pdf>.

<sup>69</sup> Bojan Markovic, *Bank Capital Channels in the Monetary Transmission Mechanism*, Bank of England Working Paper No. 313 (2006), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=965470](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=965470).

<sup>70</sup> Ruby P. Kishan & Timothy P. Opiela, *Bank Capital and Loan Asymmetry in the Transmission of Monetary Policy* 30(1) *Journal of Banking and Finance* 259 (2006), <https://www.sciencedirect.com/science/article/abs/pii/S0378426605000956>.

<sup>71</sup> Patrick Bolton & Xavier Freixas, *Corporate Finance and the Monetary Transmission Mechanism* 19(3) *REVIEW OF FINANCIAL STUDIES* 829 (2006), <https://www0.gsb.columbia.edu/faculty/pbolton/transmission.pdf>.

<sup>72</sup> Ralph Chami & Thomas F. Cosimano, *Monetary Policy with a Touch of Basel* IMF Working Paper WP/1/151, 29 (2001), <https://www.imf.org/external/pubs/ft/wp/2001/wp01151.pdf>.

<sup>73</sup> Jose-Victor Rios-Rull et al., *Banking Dynamics, Market Discipline and Capital Regulations* (2020), <https://www.sas.upenn.edu/~vr0j/papers/tvypap-SWP2.pdf>.

<sup>74</sup> Dagher et al., *supra* note 37.

economy as soon as it is adopted, if not sooner, and will continue to do so in the recovery period, even if this period actually occurs before the stated transition dates.

Thus, if contrary to the evidence reviewed above, the Agencies still believe that bank capital requirements should be increased, then the Proposal should not specify the effective date of such an increase in advance. Instead, the increase should only become effective after economic indicators demonstrate that the economy has returned to a steady state. There is a precedent for an approach that links implementation to economic circumstances rather than a specific date: The countercyclical capital buffer (“CCyB”) framework specifies a non-exhaustive set of financial sector and macroeconomic indicators that the Fed considers in determining whether to implement the CCyB, such as real estate prices, credit-to-GDP ratios, and GDP growth rates.<sup>75</sup>

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<sup>75</sup> FEDERAL RESERVE SYSTEM, *Regulatory Capital Rules: The Federal Reserve Board’s Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer*, Docket No. R-1529, 26-27 (2016), <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160908b1.pdf>.

**2. Specific issues and recommendations for modifications.**

This subpart 2 identifies specific problematic aspects of the Proposal. We recommend changes to the Proposal that could address or mitigate these issues.

In particular, although the Proposal is intended to bring the U.S into compliance with Basel III, its reforms go significantly beyond what Basel III requires. As noted above, this practice of adopting standards that are more stringent than Basel III is referred to as “gold plating.” We give particular attention to gold plating as well as aspects of the Proposal that are duplicative with other capital requirements on U.S. banks that would effectively require U.S. banks to carry capital for the same risk twice.

*A. Rationalize the approach to credit risk by rolling back gold-plating and eliminating the listing requirement for the investment grade risk weight.*

- i) Roll back gold plating of risk weights and the bar on internal models.

The Proposal gold plates Basel III’s credit risk requirements in two important respects. First, the Proposal imposes credit risk weights for mortgage loans, consumer and small business loans, and loans to other banks, that significantly exceed those that Basel III requires. Second, the Proposal prohibits the use of internal models in the calculation of credit risk weights, which Basel III does not require, and which would tend to push credit risk weights even higher.

As three important examples of gold-plated risk weights: (in) the risk weighting percentages for residential mortgage loans under Basel III vary from 20% to 105%, whereas under the Proposal they vary from 40% to 125%; (ii) the risk weighting percentage for retail lending (including credit cards, lines of credit, overdrafts, term loans and leases) under Basel III is 75%, whereas under the Proposal it is 85%; and (iii) the risk weighting percentage for a bank’s loans to other banks with a maturity of 3 months or less (“short-dated bank exposures”) under Basel III is 20%, whereas under the Proposal it is 40%.

This gold plating of credit risk combined with the new charges for operational risk will require banks to carry additional capital for activities associated with providing these types of credit relative to current requirements and thus make it costlier for banks to provide mortgage and consumer lending. Banks are likely to pass on these higher capital costs to borrowers. According to an estimate by BPI, the combination of gold-plated risk weights and additional operational risk capital could increase a bank’s costs for lending activity by 11 basis points on average. These increases in funding costs are likely to be concentrated in loans to low- and moderate-income borrowers, credit-card borrowers, and small business borrowers.<sup>76</sup>

In addition, these higher risk weights relative to Basel III will put U.S. borrowers at a competitive disadvantage relative to borrowers in jurisdictions that have not gold plated their credit risk weightings. This is because a U.S. bank will be required to carry more capital in order to extend credit relative to their non-U.S. peers and thus charge a higher interest rate to the borrower to cover

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<sup>76</sup> Francisco Covas, BANK POLICY INSTITUTE, *The Trillion Dollar Omission in Vice Chair Barr’s Cost Analysis* (Oct. 12, 2023), <https://bpi.com/the-trillion-dollar-omission-in-vice-chair-barrs-cost-analysis/>.



those costs. U.S.-based businesses will thus be required to pay more for financing than similarly situated non-U.S. companies, or seek credit from non-U.S. banks, which will disadvantage U.S. banks relative to their non-U.S. competitors. The increased risk weight for short-term bank debt will also constrain bank liquidity because it will make it more costly for banks to hold these exposures, which are an important source of liquidity for banks.

The Proposal provides no rationale for going beyond what Basel III requires in these respects. The Agencies should address this issue by rolling back its gold plating of credit risk weights so that they are no higher than those that Basel III requires and by permitting the use of internal models. U.S. borrowers will otherwise unnecessarily suffer as a result of gold-plating.

Regarding the Proposal's elimination of internal models, one of Basel III's most significant and heavily negotiated features is the continued use of internal models, including for credit risk, subject to an "output floor" that requires that internal models not produce risk-weighted assets lower than 72.5 percent of those calculated without internal models. The output floor, which the United States participated in negotiating, preserves the utility of internal models in more accurately measuring credit risk, while placing a limit on the extent to which those models can reduce a bank's capital requirements.

The European Union, United Kingdom, and all other major banking jurisdictions will follow Basel III's approach. By instead prohibiting internal models, the Proposal would effectively raise the output floor from 72.5 percent to 100 percent for U.S. banks alone. This would exacerbate the Proposal's gold plating of Basel III's risk weights and require U.S. banks to hold more credit risk capital in excess of what Basel III requires. This departure from Basel III is unwarranted, for several reasons.

First, the Agencies claim that barring internal models is necessary because these models produce unwarranted variability in banks' risk weights and may be susceptible to manipulation by banks seeking to lower their capital requirements. But since 2011, the Agencies have required U.S. banks to adhere to rigorous testing, documentation, and review criteria when using internal models to measure credit risk. Since these criteria were implemented, the Agencies have not suggested that they were ineffective in preventing unwarranted use of internal models, nor has there been a public enforcement action against a bank for using internal models to underreport its risk weights. The Proposal does not acknowledge these existing guardrails or explain why the Agencies believe they are so ineffective that they necessitate departing from a basic feature of Basel III.

Second, even if banks are barred from using internal models, measuring credit risk would continue to rely on the models that the Agencies use to determine standardized credit risk weights and that the Fed uses to model credit risk as part of the stress tests. However, the Proposal contains no empirical comparison of the effectiveness of banks' internal models at predicting credit risk versus the effectiveness of the Agency models that would govern in their place, despite the availability of historical data enabling such a comparison.

Third, internal models have significant benefits for the preservation of the stability of the banking system. In particular, internal models allow banks to measure and manage credit risk and allocate capital. Disallowing internal models disincentivizes banks from performing these functions and

instead incentivizes all banks to optimize and manage their credit exposures according to the risk weights that the Agencies set. As a result, banks will likely tend to hold similar credit portfolios, leading to a banking system that increases financial stability risk.

The Proposal should therefore not disallow banks from using internal models for credit risk.

- ii) Remove the public listing requirement for the investment grade risk weight.

In addition, the Proposal should eliminate Basel III’s listing requirement for the more favorable investment grade risk weight. Currently, the Proposal would incorporate the Basel III requirement that a corporate debtor’s securities must be traded on a securities exchange for the bank to apply the lower “investment grade” credit risk weight to that borrower’s debt securities. However, neither Basel III nor the Proposal offer any rationale for this criterion. Whether an issuer has securities listed on a securities exchange is irrelevant to the credit risk associated with holding that issuer’s securities. Imposing this criterion means that certain highly credit worthy issuers that do not have exchange-listed securities outstanding will receive the same higher risk weighting as less credit worthy issuers and thus increase the capital cost for banks to hold securities of those issuers. The Proposal would also create a strong economic incentive for banks to allocate already limited balance sheet capacity to traditional listed issuers at the expense of other highly credit worthy issuers, including regulated investment funds, undermining their access to critical liquidity. In view of the absence of any rationale for this criterion, other major jurisdictions, namely the United Kingdom and the European Union, have declined to implement Basel III’s listing criterion. The Proposal should follow the same approach.

*B. Address the double counting of market risk by integrating the FRTB and the GMS.*

The Proposal’s revised approach to market risk (known as the “Fundamental Review of Trading Book” or “FRTB”) would require banks to carry additional capital for market risks that U.S. banks are already required to account for as part of the U.S. stress testing framework. As a result, the Proposal would require U.S. banks to carry capital for the same market risks twice: once as part of their market risk RWAs, and once as part of their capital buffers as determined by the results of the stress test. The Agencies have articulated no policy rationale for this duplicative approach, which would also disadvantage U.S. banks relative to their non-U.S. peers. The Agencies should therefore modify the Proposal or other aspects of the U.S. stress testing framework to remedy this double counting. We now explain this issue in greater detail.

Market risk RWA seeks to account for the risk that the market value of a bank’s assets could decline in response to negative market events. It does so by assuming that a bank’s assets decline over a period of time following the market event, and that the bank will seek to liquidate the asset as quickly as it can to minimize its exposure to the negative price movement.

The current Basel method for calculating market risk assumes that banks can liquidate their assets within 10 days in response to market stress (i.e., banks have a 10-day “liquidity horizon”) and are thus only exposed to the portion of a negative price movement that occurs in the first 10 days following a negative market event. For example, assume the market value of an asset worth \$100 declines by 1% of its original value (i.e., \$1) each day over 30 days following an adverse market



event. If one assumes the bank can liquidate the asset 10 days after the initial shock, it receives \$90 for the asset, and is only exposed to \$10 of the total \$30 decline in market value.

The FRTB instead increases the liquidity horizon beyond 10 days (in some cases up to 120 days). The longer a liquidity horizon, the greater the bank's exposure to the total decline in market value. In the example above, if one assumes that it takes 30 days for the bank to liquidate the asset, the asset is only worth \$70 when the bank sells it, and the bank is exposed to the full \$30 decline in market value.

Thus, a longer liquidity horizon results in a higher estimate of market risk and requires banks to carry more capital with respect to market risk. The rationale for adopting longer liquidity horizons is that the current 10-day horizon is not a realistic estimate of the time a bank would need to liquidate many assets that are less liquid (e.g., securitized assets; commodities).

However, the Fed already modified the U.S. stress testing framework in a way that compensates for the potential inaccuracy of a 10-day liquidity horizon. More specifically, in 2013 the Fed added the "global market shock" ("GMS") to the stress testing methodology. The GMS is a hypothetical scenario that estimates what would happen to the value of a bank's assets in the event of severe market distress. But the GMS assumes that the decline in the value of a bank's assets occurs instantly, rather than over time, such that the bank is exposed to the full amount of the decline regardless of its liquidity horizon. Thus, whereas the current market risk RWA methodology assumes that banks are only exposed to the portion of a decline in market value that occurs during the first 10 days after an initial shock, the GMS assumes that banks are exposed to the entire reduction in market value, regardless of how quickly the bank could liquidate the asset. In the example above, the GMS would produce the same result as the FRTB by assuming that the \$100 asset declines to \$70 instantly, such that the bank can only sell the asset for \$70 (i.e., the asset's terminal value at the end of the 30-day period of decline).

U.S. banks are therefore already required to carry capital (1) as part of their market risk RWA based on a 10-day liquidity horizon, and (2) as part of their capital buffers (which are determined by the results of the stress tests) to reflect the full decline in market value of their assets in the event of a major market shock, regardless of the liquidity horizon. Thus, banks are already in effect required to assume an unlimited liquidity horizon under the GMS. By increasing the liquidity horizons used to calculate market risk RWA, the Proposal results in double counting of market risk. This is because market risk RWAs, which determine a bank's minimum capital ratios, are additive to the bank's capital buffers determined by the stress tests. The Proposal would thus require banks to carry additional capital to address a potential shortcoming in the current market risk RWA methodology that U.S. regulators already addressed by requiring U.S. banks to carry additional capital through the GMS.

The GMS was designed 10 years before the Proposal and does not take the FRTB into account. The FRTB was designed by the Basel Committee and there is no indication that the Proposal considered the GMS in implementing the FRTB. There is therefore no indication that this double counting has any underlying policy rationale. Moreover, because the GMS is a U.S.-specific rule, non-U.S. banks are not subject to the same double counting concern. U.S. banks are thus placed at



a unique competitive disadvantage. The Agencies should therefore consider how the FRTB and GMS can be integrated to avoid double counting the same market risks. For example, the Agencies could consider moderating the severity of the negative market events under the FRTB to account for the fact that banks are already required to carry capital to cover market risks under the GMS based on an effectively unlimited liquidity horizon.

*C. Rationalize the approach to operational risk by rolling back gold plating, refining the approach to service-related income, and addressing overlap with the stress tests.*

As explained in Part I, the Proposal would require banks to incorporate capital charges for operational risks into the new expanded risk-based approach to calculating RWA. These operational risk charges would account for a significant portion of the aggregate capital increases stemming from the Proposal and would ultimately require U.S. banks to hold operational risk capital that significantly exceeds what historical data indicates is necessary. Indeed, according to one estimate, the Proposal would require banks to hold 3.5 times more operational risk capital than necessary to cover the total operational losses attributable to the year 2008, which was the worst year of operational losses during at least the past 23 years.<sup>77</sup>

This overcapitalization for operational risk is attributable in significant part to (1) the Proposal’s gold-plating of Basel III’s operational risk formula via the flooring of the ILM at 1, (2) the Proposal’s failure to consider overlapping charges for operational risks already present in the Fed’s stress test models, and (3) Basel III’s punitive treatment of banks with fee-based business models, which are more prevalent in the United States relative to other jurisdictions.

The Agencies should address this overcapitalization for operational risk by at a minimum rolling back the gold plating of the operational risk formula by removing the ILM floor. The Agencies should then exercise their discretion to enact departures from Basel III, as other jurisdictions have done, to (1) neutralize the effect of the ILM on operational risk capital entirely, (2) eliminate the overlap between the new operational risk requirements and the stress tests, and (3) mitigate Basel III’s unnecessarily punitive treatment of banks’ fee income.

- i) Set the ILM to 1 or remove the ILM floor.

A bank’s operational risk capital charges would be based on the amount of the bank’s “Business Indicator Component” (“BIC”), which measures the bank’s operating income, including interest and fee income, but would be modified by the bank’s Internal Loss Multiplier (“ILM”), which is a measure of the bank’s historical operating losses. As noted in Part I, an ILM greater than 1 results in an increase to a bank’s operational risk capital, since applying a multiple of greater than 1 increases the overall measure of operational risk, whereas an ILM of less than 1 reduces it. Under Basel III, the ILM can be less than or greater than one (and can thus increase or decrease the

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<sup>77</sup> ORX, *Basel III and Standardised Approaches to Capital* (2023), <https://orx.org/resource/basel-iii-and-standardised-approaches-to-capital-2023>; Francisco Covas, BPI, *About Excessive Calibration of Capital Requirements for Operational Risk* (Oct. 30, 2023), <https://bpi.com/about-excessive-calibration-of-capital-requirements-for-operational-risk/>.

amount of required operational capital), but under the Proposal, the ILM cannot be less than one (and can thus only increase the amount of required operational capital).

Both Basel III's incorporation of historical operational losses via the ILM generally and the Proposal's specific implementation of the ILM are flawed and will result in banks carrying excessive capital for operational risk.

First, increasing a bank's operational risk capital requirements based on an attempted estimate of future operational losses (as compared with a given level of activities) is inappropriate because there is no reliable basis to estimate these losses. Past operational losses – which the Basel III and the Proposal would use to predict these losses – are unreliable predictors of future operational losses because operational losses are typically attributable to inherently unexpected and unpredictable occurrences.<sup>78</sup> Furthermore, the ILM formula effectively requires banks to carry capital to cover 15 years of operational losses, because the formula multiplies yearly historical net operational losses by a factor of 15. This element of the ILM formula was incorporated into Basel III without public comment and the Proposal does not offer any further explanation or justification of this aspect of the ILM formula. Thus, the ILM's use of historical losses to increase operational risk capital requirements is a fundamentally flawed approach.

Second, by setting a floor for the ILM of 1, which Basel III does not require, the Proposal will penalize U.S. banks for high historical losses but fail to credit banks for low historical losses. U.S. banks will therefore have higher operational risk capital requirements relative to banks in jurisdictions that follow Basel III's approach. This approach also disincentives banks from seeking to lower their operating losses.

The Agencies should address this issue by setting the ILM to 1, such that past operational losses do not increase a bank's operational capital, in line with the approaches proposed by regulators in the United Kingdom and European Union. At a minimum, the Agencies should allow banks to receive credit for low operational losses by eliminating the floor on the ILM, which no other major jurisdictions have implemented.<sup>79</sup>

- ii) Modify the BIC to avoid penalizing fee-dependent banks.

Basel III allows banks to net interest income with interest expenses, and also caps the amount by which interest income can increase the amount of banks' operational risk capital requirements. No equivalent netting or cap is provided for fee income. This approach thus penalizes banks with more fee income, such as custodial banks and banks with more capital markets activities, which are of disproportionate importance to the U.S. banking sector relative to other jurisdictions. When an earlier draft of the Basel III standards was proposed in 2016, it included a cap for fee income so as to equalize the treatment of interest and fee income under the operational risk capital rules. But this cap was omitted without explanation from the final version of Basel III, and the Proposal has

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<sup>78</sup> BANK POLICY INSTITUTE, *Operational Risk: What It Means and Why It Matters* (Apr. 21, 2023), <https://bpi.com/operational-risk-what-it-means-and-why-it-matters/>.

<sup>79</sup> *Id.*



followed Basel III in not implementing a cap. Neither Basel III nor the Proposal offers any justification for penalizing fee-dependent banks in this manner.

This punitive treatment of fee income is particularly unwarranted as service-oriented lines of business have historically exhibited very low operational losses. Furthermore, the treatment of such income is of heightened importance to U.S. banks where fee-generating lines of business prevail to a greater extent compared to their non-U.S. peers.

The Agencies should therefore amend the Proposal to mitigate the unduly onerous treatment of fee income under the operational risk capital rules, for example by adopting a “net” view of fee income allow for the netting of expenses, consistent with the treatment of interest income.

- iii) Address the double counting of operational risk by integrating operational risk requirements and the stress test methodologies.

The Proposal’s introduction of a new charge for operational risk into the standardized approach presents a similar “double counting” issue as exists with respect to market risk. Namely, there is already an operational risk component in the stress test methodologies, such that a bank’s SCB already includes a component to cover operational risks. The Proposal presents no rationale for this overlap or indication that the Agencies considered it in designing the Proposal.

One way of addressing this overlap would be to modify the stress test methodologies to account for the additional operational risk capital that banks will be required to carry under the Proposal. Alternatively, the Agencies could adjust the Proposal to account for the operational risk capital a bank is already required to hold as part of its SCB. Although this latter approach may entail departures from the literal requirements of Basel III, the Agencies have the discretion to depart from Basel III, especially where an aspect of its provisions cannot be rationally justified as it applies to U.S. banks.

Indeed, banking authorities in other jurisdictions have exercised this authority to enact departures from Basel III’s requirements where those jurisdictions determined that an aspect of Basel III could not be adequately justified. For example, authorities in the United Kingdom and European Union have declined to implement the minimum haircut floors on securities financing transactions on the basis of concerns with the validity of those floors.

Modifying Basel III’s operational risk provisions as necessary to account for existing operational charges inherent in the stress tests present an even stronger case for the exercise of the Agencies’ discretion to depart from the literal requirements of Basel III, because the stress tests are a unique feature of U.S. capital regulation that other jurisdictions do not share, and that Basel III does not consider.

*D. Retain the 25% simplified deduction framework for Category III and IV banks.*

The Proposal’s more restrictive approach to capital deductions, particularly as it applies to MSAs and DTAs, would have an immediate adverse impact on Category III and IV banks and on the U.S. financial system more generally. In particular, the overly restrictive treatment of MSAs, combined with the Proposal’s gold-plated risk-weights for mortgage lending, would curtail banks’ ability to

engage in mortgage lending and servicing activities, pushing even more mortgage lending and servicing activities to less regulated non-bank entities.

Furthermore, the Proposal’s treatment of DTAs would result in Category III and IV banks curtailing their consumer lending. Banks are required to hold allowances for loan losses, which give rise to DTAs due to the timing differences in tax deductions. An increase in allowances for loan losses would result in a corresponding increase in associated DTAs. Banks that focus on consumer lending typically have larger DTAs with fewer offsets due to the nature of their lending businesses, and therefore a lower deduction threshold for DTAs would affect these banks more. The implementation of the current expected credit losses methodology (“CECL”) in 2020 exacerbated this concern as CECL significantly increased the allowances across the industry, which in turn drove up the associated DTAs.

The Proposal’s 10% and 15% limits were not calibrated with CECL in mind and are overly punitive. Further compounding the adverse impact is the Proposal’s removal of the AOCI opt-out for Category III and IV banks, described in Part I above. Unrealized losses recognized in AOCI can also lead to the recognition of DTAs. As a result, the combined impact of the removal of the AOCI opt-out and a lower limit for DTAs would be greater reductions in CET1 capital, which would in turn increase the capital requirements for Category III and IV banks. Such an increase is unwarranted and would adversely affect consumer lending activities.

The current 25% deduction framework was established by the Agencies’ 2019 capital simplification rule, which was the product of a multi-year review pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996 and an extensive notice-and-comment rulemaking process.<sup>80</sup> The Proposal provides no explanation as to why the current 25% simplified framework is no longer appropriate for Category III and IV banks and fails to consider the adverse impact of such changes on the banks’ mortgage servicing and consumer lending activities. The Proposal should therefore maintain the current 25% deduction framework.

*E. Refrain from implementing the minimum haircut floor provisions.*

The Agencies should not implement the minimum haircut floor provisions, for several reasons. First, other major jurisdictions, including the European Union and United Kingdom, have chosen not to implement these provisions, having identified valid and significant concerns with their current structure. These concerns include that imposing such a floor creates a cliff effect that could incentivize banks and counterparties to enter into fully uncollateralized transactions when they are unable to meet a haircut floor and that transactions that do not meet the floor could simply shift into the shadow-banking sector. An analysis by the European Banking Authority therefore recommended “withhold[ing] the implementation in the EU of the minimum haircut floors

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<sup>80</sup> OFFICE OF THE COMPTROLLER OF THE CURRENCY, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM; FEDERAL DEPOSIT INSURANCE CORPORATION, *Regulatory Capital Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*, 84 FED. REG. 35,234 (July 22, 2019).



framework for SFTs in the capital framework as designed in . . . Basel III.”<sup>81</sup> The United States would thus be an outlier in subjecting its banks to the minimum haircut floors.

Second, the Agencies’ legal authority to impose the minimum haircut floor is questionable. As noted above, the Agencies’ intention in imposing these provisions is evidently to limit non-bank leverage. However, the Agencies cannot use their authority to set bank capital requirements as a mere pretext to limit the leverage of non-banks. Although the Federal Reserve may have broader authority to use margin requirements to limit leverage more widely, this authority is separate from the Agencies’ authority to implement Basel III, which is the authority that underlies the Proposal.

If the Agencies nonetheless determine to retain the minimum haircut floor provisions in the Proposal, they should retain the exception for Treasury securities and other non-defaulted sovereign debt. First, the exception for non-defaulted sovereign exposures is a part of Basel III. Removing the exception would thus, in view of the concerns outlined below, constitute unnecessary and costly gold plating. In particular, failing to retain this exception could have unintended consequences for Treasury markets. For example, an analysis by the Federal Reserve estimated that imposing a 200-bps minimum haircut on Treasury collateral would cause hedge funds to reduce their Treasury holdings by 30%, which could lead to increased volatility and reduced liquidity in Treasury markets.<sup>82</sup> Removing this exception may also be unnecessary given the new central clearing rules for Treasury repo transactions, which are intended to address any financial stability risks the Agencies may perceive with respect to non-bank leverage. The Fed should at the minimum wait to see the impact of central clearing.

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<sup>81</sup> EUROPEAN BANKING AUTHORITY, *Policy Advice on the Basel III Reforms on Securities Financing Transactions (SFTs)* (2019), [https://www.eba.europa.eu/sites/default/files/document\\_library/881123/Policy%20Advice%20on%20Basel%20III%20reforms%20-Credit%20Risk.pdf](https://www.eba.europa.eu/sites/default/files/document_library/881123/Policy%20Advice%20on%20Basel%20III%20reforms%20-Credit%20Risk.pdf).

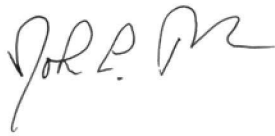
<sup>82</sup> Ayelen Banegas & Phillip Monin, FEDS Notes, *Hedge Fund Treasury Exposures, Repo, and Margining* (2023), <https://www.federalreserve.gov/econres/notes/feds-notes/hedge-fund-treasury-exposures-repo-and-margining-20230908.html>.

COMMITTEE ON CAPITAL MARKETS REGULATION


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Thank you very much for your consideration of the Committee's position. Should you have any questions or concerns, please do not hesitate to contact the Committee's President, Professor Hal S. Scott (hscott@law.harvard.edu), or its Executive Director, John Gulliver (jgulliver@capmksreg.org), at your convenience.

Respectfully submitted,



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