



January 16, 2024

*Via Federal eRulemaking Portal*

Chief Counsel's Office Attention: Comment Processing  
Office of the Comptroller of the Currency  
400 7<sup>th</sup> Street, S.W., Suite 3E-218  
Washington, D.C. 20219  
Docket No. OCC-2023-0008

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Secretary  
Board of Governors of the Federal Reserve System  
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Washington, D.C 20551  
Docket No. R-1813, RIN 7100-AG64  
Docket No. R-1814; RIN 7100-AG65

James P. Sheesley  
Assistant Executive Secretary  
Attention: Comments/Legal OES (RIN 3064-AF29)  
Federal Deposit Insurance Corporation  
550 17<sup>th</sup> Street, N.W.  
Washington, D.C. 20429  
RIN 3064-AF29

Re: Regulatory Capital Rule: Amendments Applicable to Large Banking Organizations and to Banking Organizations with Significant Trading Activity (OCC Docket No. ID OCC-2023-0008; Federal Reserve Docket No. R-1813, RIN 7100-AG64; FDIC RIN 3064-AF29);<sup>1</sup> Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15) (Federal Reserve Docket No. R-1814; RIN 7100-AG65)<sup>2</sup>

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<sup>1</sup> The Notice of Proposed Rulemaking was jointly issued by the Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve") and the Federal Deposit Insurance Corporation (the "FDIC" and collectively with the OCC and the Board, the "Agencies"), *Regulatory Capital Rule: Amendments to Large Banking Organizations and to Banking Organizations with Significant Trading Activity*, 88 Fed. Reg. 64028 (September 18, 2023).

<sup>2</sup> Board of Governors of the Federal Reserve System, *Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)*, 88 Fed. Reg. 60385 (September 1, 2023).

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. (“Goldman Sachs,” “we” or “our”) appreciates the opportunity to comment on the jointly issued notice of proposed rulemaking to modify the regulatory capital rules to implement the Basel III Endgame (“B3E NPR”), as well as the Federal Reserve’s notice of proposed rulemaking to modify its risk-based capital surcharge for Global Systemically Important Banking Organizations (“G-SIB NPR,” and collectively with the B3E NPR, the “NPRs”).

Goldman Sachs is a leading global financial institution that delivers a broad range of financial services to a large and diversified client base that includes corporations, financial institutions, pension plans, mutual funds, governments and individuals. We offer our clients financing options to expand their businesses domestically and abroad, and we advise our clients on buying and selling businesses and raising capital. Goldman Sachs also serves as a crucial risk advisor to help businesses navigate challenges and financial risks that range from currency fluctuations and commodity price volatility to interest rate variations and credit risk. In addition, we finance infrastructure projects for local governments to invest in schools, hospitals and roads.

We are a capital markets-focused banking organization, and we support rules and regulations that ensure the safety and soundness of financial markets, which ultimately serve American businesses, consumers and taxpayers. Since the Global Financial Crisis (“GFC”), the U.S. federal regulatory agencies (“the Agencies”) have implemented a series of reforms to protect the financial system. These include increasing the amount and quality of capital that banking organizations must hold, restricting banking organizations from taking on excessive leverage or taking undue risk supported by federally insured deposits and limiting the exposure that financial institutions can have to one another. These reforms address financial, operational and other risks and ensure banks hold an appropriate amount of loss-absorbing capital against them. Recent events that resulted in market disruptions have shown the efficacy and sufficiency of these reforms in aggregate, particularly with respect to the U.S. G-SIBs.

As recently confirmed in the 2023 annual report of the Financial Stability Oversight Council (“FSOC”),<sup>3</sup> U.S. G-SIB capital is at historic highs. Federal Reserve Chair Jerome Powell echoed this fact in a statement in July 2023: “The U.S. banking system is sound and resilient, with strong levels of capital and liquidity.”<sup>4</sup> We fully agree with Powell’s assessment, as high levels of capital and liquidity enabled U.S. G-SIBs to serve as a source of strength throughout several recent crises, especially the COVID-19 pandemic.

Notwithstanding these facts, if the NPRs are implemented as proposed, Goldman Sachs’ required capital is expected to increase by more than 25%. Moreover, according to a quantitative impact study using data as of the second quarter of 2023, the NPRs are expected to increase capital in the aggregate for the U.S. G-SIBs by more than 30%, while increasing risk-weighted assets (“RWA”) by 33%.<sup>5</sup> This is significantly higher than the Agencies’ estimates in the preamble to the B3E NPR, which were based on data as of year-end 2021 and which did not reflect (1) that G-SIB capital surcharges for some U.S. banks are set to increase in 2024, (2) the impact of the recent G-SIB NPR and (3) the evolution of RWA at U.S. G-SIBs since that date. In addition, many of the most costly aspects of the NPRs, especially as they relate to capital markets activities, have not been and will not be implemented by international regulatory authorities, further exacerbating the disparities impacting U.S. G-SIBs compared to international peers.

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<sup>3</sup> The 2023 FSOC annual report concluded that “the U.S. financial system remains resilient” and “U.S. banks continue to have sound levels of regulatory capital.” The report also noted that “in the case of G-SIBs, the CET1 capital ratio has trended up since early 2022 and is now on par with the highest levels observed in more than 20 years.” *FSOC 2023 Annual Report*, prepared by the Financial Stability Oversight Committee (Washington, DC, 2023). <https://home.treasury.gov/system/files/261/FSOC2023AnnualReport.pdf>.

<sup>4</sup> Statement by Chair Jerome H. Powell, Board of Governors of the Federal Reserve System (July 27, 2023), <https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20230727.htm>

<sup>5</sup> Financial Services Forum et al., Comment Letter on Proposed Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (December 22, 2023), <https://financialservicesforum.cmail19.com/t/r-l-titjhje-nbiduyuy-y/>.

We believe the NPRs are materially flawed and substantially mis-calibrated. We have focused our comments in this letter on those aspects of the NPRs that are most impactful to capital markets activities, including the B3E NPR's revised treatment of market-making activity under the Fundamental Review of the Trading Book ("FRTB") and the addition of credit valuation adjustment ("CVA") capital requirements. These rules drive our significant increase in required capital because they are combined with the Global Market Shock ("GMS") in the Federal Reserve's annual stress tests without consideration for how they and the GMS interact. Higher capital is not costless, and the Agencies should be cautious regarding the potential impact of these increases on markets, businesses and individual Americans. Critical flaws in the NPRs will increase the cost of intermediation, reduce U.S. economic competitiveness and shift activity to the non-regulated, non-bank sector.<sup>6</sup> We are hopeful that through the comment process, these issues will be appropriately considered.

In our view, the NPRs do not strike the right balance between strong capital requirements and allowing banks to continue lending to households and businesses and intermediating in the financial markets. We therefore strongly recommend that the Agencies re-propose the NPRs, taking into account the specific recommendations detailed in this letter as well as Appendix A and do so only after sufficient study, based upon recent data, is conducted and made available to the public. This process should be conducted according to the Agencies' customary rulemaking process which includes a comment period. In addition to the issues discussed in this letter, there are a number of other important comments in the letters from the Financial Services Forum ("FSF"), the Securities Industry and Financial Markets Association ("SIFMA"), the Bank Policy Institute ("BPI"), the American Bankers Association ("ABA"), the Futures Industry Association ("FIA"), the International Swaps and Derivatives Association ("ISDA") and the Structured Finance Association ("SFA"). We are an active member of these organizations and fully support the recommendations of their letters.

## **Background**

### **I. G-SIBs Drive U.S. and Global Economic Growth by Facilitating Robust Capital Markets: A Strategic Asset to the United States**

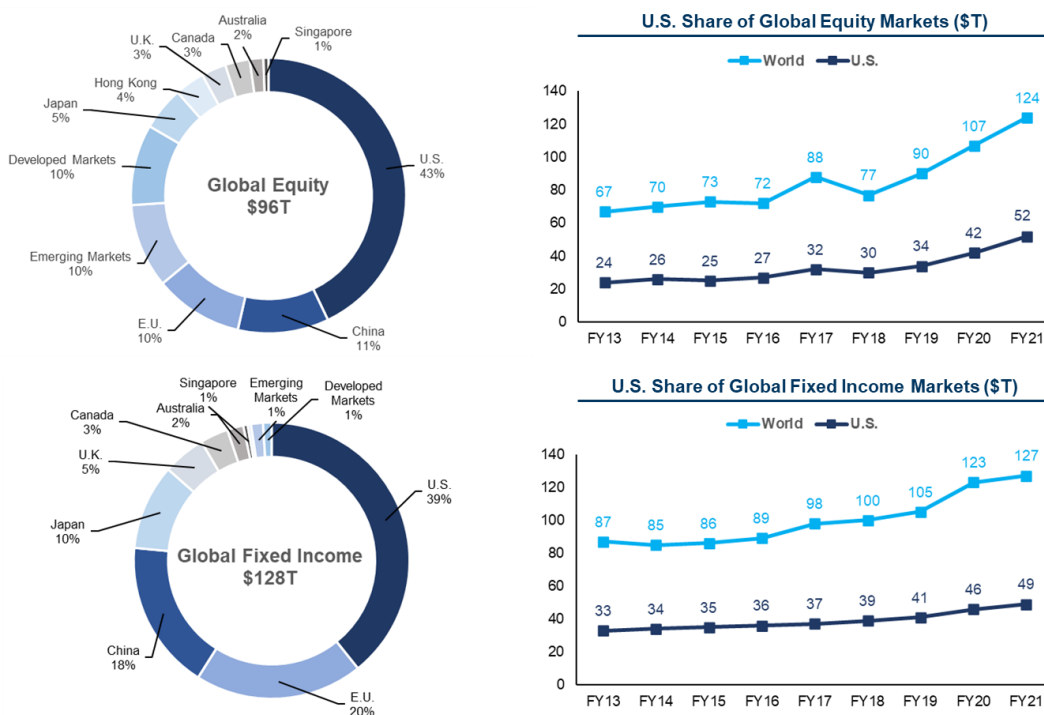
The U.S. capital markets are the deepest, most dynamic and most liquid in the world, and are the backbone of U.S. economic strength and resilience. Notably, the U.S. equity markets represent 43% of the \$96 trillion in global equity market capitalization, which is four times the next largest market, China. Similarly, the U.S. fixed income markets comprise 39% of the \$128 trillion securities outstanding across the globe, as illustrated in Figure 1 below.<sup>7</sup>

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<sup>6</sup> A working group within the Group of 30 (G30), which was chaired by former President of the Federal Reserve Bank of New York Bill Dudley and comprised of current and former leaders of central banks and financial agencies globally, recently issued a report, which noted that "sharply increasing capital requirements ... could make banks less competitive and drive more activity into the (less-regulated) nonbank system." *Bank Failures and Contagion*, published by the G30 Working Group on the 2023 Banking Crisis, January 2024, [https://group30.org/images/uploads/publications/G30\\_Lessons-23-Crisis\\_RPT\\_Final.pdf](https://group30.org/images/uploads/publications/G30_Lessons-23-Crisis_RPT_Final.pdf) (the "G30 Banking Report").

<sup>7</sup> Securities Industry and Financial Markets Association, *2023 Capital Markets Outlook*, 2023, 9, <https://www.sifma.org/wp-content/uploads/2022/12/2023-Capital-Markets-Outlook-SIFMA.pdf>.

Figure 1



Source: World Federation of Exchanges (as of October 2022), Bank of International Settlements (as of March 2022)  
 Note: Equity = market cap, fixed income includes structured products = securities outstanding. E.U. = 27 member states.

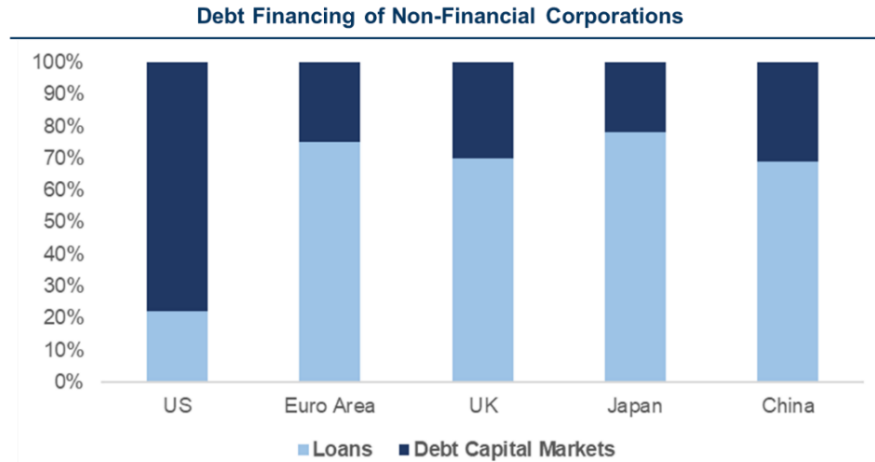
Capital markets are critical to financing economies and supporting economic growth; 75% of financing for U.S. businesses and state and local governments is obtained through capital markets.<sup>8</sup> By comparison, capital markets account for only 25% of corporate lending in the E.U., where traditional bank lending predominates and a public policy objective exists to develop capital markets that resemble those in the United States.<sup>9</sup> Figure 2 below illustrates that the use of debt capital markets is more prevalent in the United States compared to other regions.<sup>10</sup>

<sup>8</sup> Ibid., 10.

<sup>9</sup> Paschal Donohoe, Werner Hoyer, Christine Lagarde, Charles Michel and Ursula von der Leyen, "Channeling Europe's Savings into Growth," *The ECB Blog*, March 9, 2023, <https://www.ecb.europa.eu/press/blog/date/2023/html/ecb.blog.230309~addaac5e08.en.html>.

<sup>10</sup> Securities Industry and Financial Markets Association, *2023 Capital Markets Outlook*, 10.

*Figure 2*



Source: Organization for Economic Co-operation and Development, European Central Bank, Bank of Japan, National Bureau of Statistics of China, Federal Reserve (as of 2021, China 2018)

Note: Euro Area = 19 EU-member states using the Euro. Debt capital markets = corporate bonds only.

The U.S. capital markets are also internationally significant and therefore are a strategic asset to the United States. They are the top choice for foreign companies looking to list their equity securities in another market. While U.S. companies rarely list overseas, foreign companies choose U.S. exchanges twice as often as any other jurisdiction, providing additional flexibility for U.S. investors, increased fee revenue for U.S. financial institutions and higher tax revenues for the U.S. government.<sup>11</sup> Goldman Sachs and other U.S. G-SIBs have played a critical role in the success of the U.S. capital markets. On average, throughout 2021 and 2022, U.S. G-SIBs underwrote nearly three-quarters of debt and equity transactions among large institutions in the United States.<sup>12</sup>

In addition to traditional equity and debt financings, we enter into commodities transactions with U.S. manufacturers so they can hedge the future price of inputs, and with power generators and utilities so they can hedge fluctuations in energy prices. We facilitate transactions with various clients looking to hedge the risk of price fluctuations in financial indices. We also engage in securities financing transactions (“SFTs”) where we borrow stock from, for example, pension funds in exchange for cash so they can manage distributions to investors and retirees. We provide interest rate hedges to real estate developers so they can protect against higher interest rates on their real estate loans. We also match securities lenders and borrowers in funding markets and clear securities on behalf of clients. In connection with all of these activities, we are part of the critical infrastructure that helps make the U.S. capital markets function.

We can facilitate our clients’ activities in the capital markets because of the strength of our balance sheet and our resilience. Capital is a scarce resource and if the cost of capital markets activities significantly increases, we will need to make difficult choices about how to best allocate capital going forward. These decisions could result in an increase in the price of our services to clients, a reduction in our services or an exit from certain markets altogether.

<sup>11</sup> Securities Industry and Financial Markets Association, *Capital Markets Report – Modernizing and Rationalizing Regulation of The U.S. Capital Markets*, August 10, 2017, 4, <https://www.sifma.org/wp-content/uploads/2017/08/Capital-Markets-Report-%E2%80%93-Modernizing-and-Rationalizing-Regulation-of-the-U.S.-Capital-Markets.pdf>.

<sup>12</sup> Financial Services Forum, *The Value and Strength of America’s Largest Financial Institutions*, March 2023, 12, <https://fsforum.com/a/media/forum-value-and-resiliency2022q4.pdf>.

## II. Post-Crisis Reforms Have Made G-SIBs a Source of Strength for Capital Markets and Economic Growth

The many prudential reforms instituted by the Dodd-Frank Act<sup>13</sup> and other requirements have improved the safety and soundness of both U.S. banks and the U.S. financial system and help ensure that U.S. G-SIBs can continue to serve clients during periods of economic uncertainty or stress.<sup>14</sup> Policymakers around the world agree that U.S. G-SIBs are the most highly capitalized financial institutions in the world and that they have continued to serve as a source of strength to the U.S. economy throughout a number of recent, acute crises. Despite this, the U.S. G-SIBs stand to be most adversely impacted by the NPRs. The specific impact on capital markets-related activity is a particular concern as the NPRs are significantly more stringent when compared to the implementation standards in other large jurisdictions. Furthermore, the proposed requirements come on top of existing U.S. capital requirements, which are already some of the highest in the world and are more conservatively calibrated than the Basel standard.<sup>15</sup>

Since the end of 2007, as a result of reforms implemented in the aftermath of the GFC, U.S. G-SIBs have significantly grown the quantity and enhanced the quality of their capital. Goldman Sachs' capital has nearly tripled, our liquidity has increased more than five times and our leverage has decreased by 50%. We have significantly more capital and Total Loss-Absorbing Capacity ("TLAC") that could be converted to equity if our equity capital falls below the regulatory required minimums. In fact, our TLAC is almost double its current regulatory requirement at 41.5% of Standardized RWA as of 3Q23. We have also reduced the percentage of our liabilities that consist of short-term wholesale funding and reduced complex forms of non-common Tier 1 and Tier 2 capital, while at the same time we have significantly increased the percentage of our assets consisting of cash and other high-quality liquid assets. The Federal Reserve's annual stress tests as well as a multitude of internal stress scenarios consistently confirm that we can withstand an instantaneous financial market shock and unexpected severe global recession.

U.S. G-SIBs proved to be a source of strength to the financial system during the COVID pandemic, the invasion of Ukraine, the highest inflation in decades and the regional bank crisis of early 2023. At no point during these events did regulators or the public call into question the capital adequacy of Goldman Sachs or any other U.S. G-SIBs. Quite the opposite, U.S. G-SIBs were part of the solution; for example, by stabilizing the balance sheet of First Republic through the placement of large uninsured deposits.<sup>16</sup> Further,

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<sup>13</sup> Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 124 Stat. 1376 (2010). See Appendix D for a more comprehensive list of reforms.

<sup>14</sup> "The financial markets have been functioning well and the banking system in particular is very strong, well-capitalized." *Hearing on Monetary Policy, Before the House Committee on Financial Services*, 117th Cong. 36 (2022) (testimony of Jerome H. Powell, Federal Reserve Chair)

<sup>15</sup> Andrea Enria, Chair of the Supervisory Board of the ECB, "Banking supervision beyond capital," (speech, Santiago de Compostela, Spain, September 14, 2023), EUROFI 2023 Financial Forum, <https://www.bankingsupervision.europa.eu/press/speeches/date/2023/html/ssm.sp230914-c6c0be0cc6.en.html> ("Relative to their actual requirements today, we find the average requirement for European banking union significant institutions as a whole would be somewhat higher under the U.S. rules. The requirements would be significantly higher for the European G-SIBs, while they would be lower for most medium size and smaller European banks in the sample.").

<sup>16</sup> See Joint Statement by the Department of the Treasury, Federal Reserve, FDIC and OCC that "11 banks announced \$30 billion in deposits into First Republic Bank. This show of support by a group of large banks is most welcome, and demonstrates the resilience of the banking system." Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of the Comptroller of the Currency, "Joint Statement by the Department of the Treasury, Federal Reserve, FDIC and OCC," press release, March 16, 2023, <https://home.treasury.gov/news/press-releases/jy1349>. See also Readout from the Treasury Department that after meeting with more than two dozen bank CEOs, she "reaffirmed the strength and soundness of the U.S. banking system, noting that it remains well-capitalized with strong liquidity." U.S. Department of Treasury, "READOUT: Secretary of the Treasury Janet L. Yellen's Meeting with Bank Policy Institute," press release, May 18, 2023, <https://home.treasury.gov/news/press-releases/jy1492>. See *FDIC's Supervision of First Republic Bank*, prepared by the Federal Deposit Insurance Corporation (Washington, DC, 2023), 20, Figure 5 (showing that the \$30 billion of uninsured deposits placed at First Republic Bank on March 16, 2023 by a consortium of large U.S. banks

banking activity and deposits migrated to G-SIBs during these periods, reflecting their ability – as shown by Federal Reserve research – to act as shock absorbers.<sup>17</sup> For all these reasons, Treasury Secretary Janet Yellen<sup>18</sup> and other government officials of both political parties<sup>19</sup> across three administrations have repeatedly stated that the largest banks are strong and well-capitalized. For example, in December 2023, Treasury Secretary Yellen stated that, "despite facing tighter financial conditions and heightened global economic uncertainty over the last year, the U.S. financial system remains resilient. The U.S. banking system as a whole is sound, with strong capital and liquidity positions."<sup>20</sup>

### **III. The B3E International Reforms Were Intended to Improve International Comparability and Were Capital Neutral, But the NPRs Reduce Comparability and Increase Requirements**

The B3E international reforms were intended to create a common set of international capital standards that would improve comparability among financial institutions globally. As then Basel Committee Chair Stefan Ingves stated at the time, the reforms "will improve the comparability and transparency of banks' risk-based capital ratios."<sup>21</sup> Further, as the Basel III Monitoring Report published at the same time concluded, "[f]inalization of Basel III results in no significant increase in overall capital requirements," and in fact resulted in a slight aggregate decrease for the 96 internationally active "Group 1" banks.<sup>22</sup> In addition, Federal Reserve officials previously indicated that the B3E international standards would be implemented in the U.S. in a way that was capital neutral in the aggregate, i.e., increases in capital in one area would be offset by capital reductions in other areas.<sup>23</sup> For example, in a 2020 testimony before the House Financial Services Committee Chair Jerome Powell stated: "My strong view is that capital, the levels of capital,

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including Goldman Sachs, accounted for more than half of First Republic Bank's uninsured deposits as of March 24, 2023).

<sup>17</sup> Abboud, Alice *et al.*, "COVID-19 as a Stress Test: Assessing the Bank Regulatory Framework," *Finance and Economics Discussion Series* 2021-024, Washington: Board of Governors of the Federal Reserve System (2021), <https://doi.org/10.17016/FEDS.2021.024>. Furthermore, this Federal Reserve research paper on the impact that COVID-19 had on the U.S. banking sector noted that "trading activity strengthened firms during this period."

<sup>18</sup> Janet L. Yellen, Secretary of the U.S. Department of Treasury, Remarks at the Open Session of the meeting of the Financial Stability Oversight Council, November 3, 2023, <https://home.treasury.gov/news/press-releases/jy1875> ("...the U.S. financial system remains resilient. The U.S. banking system as a... is sound, with strong capital and liquidity positions.").

<sup>19</sup> *Hearing on Annual Oversight of Wall Street Firms, Before the Senate Committee on Banking, Housing, and Urban Affairs*, 118th Cong. (2023) (statement by Senator Steve Daines (R-MT)) ("In fact, every regulator I have questioned this year at hearings like this has confirmed...the U.S. banking system is strong. It's well capitalized."). See also *Hearing on Enabling Success: Examining the Competitive Landscape for Small Businesses, Before the House Committee on Small Business, Subcommittee on Economic Growth, Tax, and Capital Access*, 118th Cong. (2023) (statement by Representative David Scott (D-GA)) ("Since [the GFC], our banking system has successfully navigated very difficult periods, including the recent 2020 COVID economic shock. But now, I'm very concerned with the unintended economic consequences of this proposed rule and its potential impact on our banking institutions as they engage in critical market activities.").

<sup>20</sup> Janet L. Yellen, Secretary of the U.S. Department of Treasury, Remarks at the Open Session of the meeting of the Financial Stability Oversight Council, December 14, 2023, <https://home.treasury.gov/news/press-releases/jy1990>.

<sup>21</sup> Basel Committee on Banking Supervision, *Governors and Heads of Supervision finalise Basel III reforms*.

<sup>22</sup> Basel III Monitoring Report (Basel, Switzerland: Basel Committee on Banking Supervision, 2017), 1, <https://www.bis.org/bcbs/publ/d426.pdf>.

<sup>23</sup> Mark Van Der Weide, Federal Reserve General Counsel, Remarks on an ABA panel, January 6, 2022 ("We're also committed to putting these [Basel III Endgame] reforms in place in a way that's roughly capital-neutral for the U.S. banking system.").

particularly in the largest institutions, are about right, and there is not a need to raise or to lower them, and that should reflect that... Capital levels are much higher and the quality of our capital is much higher.”<sup>24</sup>

The NPRs do not achieve the Basel Committee’s stated original design goal of reducing risk-weight variability and improving comparability of capital across internationally active banks because E.U. implementation is largely capital neutral.<sup>25</sup> Mario Draghi, the Chair of the Group of Governors and Heads of Supervision and President of the European Central Bank at the time of finalizing the Basel standard in 2017, noted that for the E.U. “... the implementation should avoid a significant increase in overall capital requirements... and take into account specificities of the E.U. economy... [and] should help avoid competitive disadvantages for E.U. institutions, in particular in the area of trading activities, where E.U. institutions directly compete with their international peers.”<sup>26</sup> In contrast, this sentiment, which is ultimately reflected in the E.U.’s implementation of B3E (see Appendix B for jurisdictional implementation differences) is not consistent with the Agencies’ NPRs as they would significantly increase U.S. capital requirements relative to E.U. standards.

Federal Reserve Chair Jerome Powell acknowledged the relatively high U.S. capital requirements in his statement on the B3E NPR: “[T]he proposal exceeds what is required by the Basel agreement and exceeds as well what we know of plans for implementation by other large jurisdictions.”<sup>27</sup> The NPRs therefore place U.S. G-SIBs and other U.S. banking organizations at a competitive disadvantage relative to non-U.S. banking organizations. This is driven by, among other things, the total removal of internal modeling for credit risk and the capture of the same risks across multiple areas of the capital rules (e.g., trading and counterparty risk in both RWA calculations and stress testing). As illustrated in Appendix B, other jurisdictions have materially deviated from the B3E international standards to alleviate the impact on their banks and end-users<sup>28</sup>. The United States, however, is proposing to fully adopt these provisions, and in several instances calibrate them more stringently than the Basel standard.

As previously noted, a quantitative impact analysis done by U.S. banking organizations based on data from the second quarter of 2023 found that the NPRs are expected to increase capital in the aggregate for the U.S. G-SIBs by more than 30%. As with most major regulatory reforms implemented since the GFC, the majority of the increase will apply to capital markets-related activities conducted by the largest U.S. banks, a point which Vice Chair for Supervision Michael Barr has highlighted on multiple occasions.<sup>29</sup> The B3E NPR acknowledges that it increases market risk capital requirements by an estimated 77% in the aggregate (or more for some banks), while also acknowledging “[t]he overall effect of higher capital requirements on market making activity and market liquidity remains a research question needing further study.”<sup>30</sup>

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<sup>24</sup> *Hearing on Monetary Policy and the State of the Economy, Before the House Committee on Financial Services*, 116th Cong. (2020) (testimony of Jerome H. Powell, Federal Reserve Chair).

<sup>25</sup> Basel Committee on Banking Supervision, *Basel III: Finalising post-crisis reforms* (2017), 1 (“The revisions to the regulatory framework set out in this document will help restore credibility in the calculation of RWA by: (i) enhancing the robustness and risk sensitivity of the standardised approaches for credit risk and operational risk, which will facilitate the comparability of banks’ capital ratios.”), <https://www.bis.org/bcbs/publ/d424.pdf>.

<sup>26</sup> Basel Committee on Banking Supervision, *Governors and Heads of Supervision finalise Basel III reforms*.

<sup>27</sup> Jerome Powell, Chair of the Federal Reserve, Joint Press Release, July 27, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/powell-statement-20230727.htm>.

<sup>28</sup> Unless specified otherwise, “end-user” refers to a commercial end-user of financial services throughout this letter.

<sup>29</sup> See, e.g., *Hearing on Oversight of Financial Regulators: Protecting Main Street Not Wall Street, Before the Senate Committee on Banking, Housing, and Urban Affairs*, 118th Cong. 7 (2023) (testimony of Michael S. Barr, Federal Reserve Vice Chair for Supervision) (“The proposed rules are anticipated to increase capital requirements for large banks, but the effects for each bank would vary based on its activities and risk profile. Notably, the increases would be most substantial for the largest and most complex banks, and the bulk of the estimated rise is attributable to trading and other non-lending activities.”).

<sup>30</sup> 88 Fed. Reg. 64028, 64170-64171.



## Fundamental Flaws of the NPRs

### I. The NPRs Result in Excessively High Capital Requirements, Especially When Combined with Stress Testing Requirements

Certain of the more punitive aspects of the NPRs (including capital requirements relating to operational risk, market risk and CVA)<sup>31</sup> would require banks to hold additional capital for risks that are already captured through stress testing. The most significant example of this is the interplay between the GMS and the proposed FRTB. Both are intended to ensure a bank can endure a severe market stress, both capture market risk losses, and both estimate those losses based on extreme tail events. Further, both frameworks use market shocks calibrated based on similar historical loss data, both constrain the effects of credit risk mitigation and portfolio diversification, and both use similarly severe liquidity horizon assumptions. Notwithstanding these similarities, Vice Chair for Supervision Michael Barr has argued that the idea that certain risks are double-counted in the capital framework is “conceptually flawed.” He has stated that the Stress Capital Buffer (“SCB”) is intended to create buffers to capitalize for a stress event, while the static risk-based capital framework is designed to ensure a firm has minimum capital levels to remain viable subsequent to the event.<sup>32</sup> Regardless, when FRTB and GMS are combined, the result is excessive required capital.

On its own, the GMS represents one of the largest components of required capital for several G-SIBs. A 2019 SIFMA study suggests that several factor shocks have less than a 1-in-10,000 chance of occurring based on historical data.<sup>33</sup> When combined with the FRTB, capital requirements reflect a stress event that is even less plausible, particularly given the assumption that GMS losses occur on a single day and FRTB losses occur over a ten-day period. Figure 3 shows that for several asset classes, the combined shocks from GMS and FRTB far exceed those experienced in the most severe shock that happened over a six-month period. For BBB corporate bonds, the GMS alone exceeds the most severe losses experienced over a six-month period for that asset class since 2008. When GMS shocks are combined with the FRTB, capital requirements for certain exposures can even exceed maximum potential loss, which is an implausible outcome. Governor Michelle Bowman expressed similar concern with this effect, stating that “the proposal introduces new regulatory redundancies, as with changes to the market risk capital rule, credit valuation adjustments, and operational risk that overlap with stress testing requirements and the stress capital buffer.”<sup>34</sup>

One way to address this redundancy would be to apply risk weights to an exposure amount that is reduced by losses already incurred in the Federal Reserve’s hypothetical stress scenario. This would be conceptually consistent with Vice Chair for Supervision Michael Barr’s description of the static risk-based capital framework as the component of capital requirements that ensures banks have adequate capital after a stress event.

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<sup>31</sup> CVA risk arises from derivative price adjustments when the creditworthiness of a counterparty deteriorates.

<sup>32</sup> Michael Barr, Vice Chair for Supervision, “Multiple Scenarios in Stress Testing,” (in Q&A after speech, Boston, Massachusetts, October 19, 2023), Stress Test Research Conference at the Federal Reserve Bank of Boston, <https://www.federalreserve.gov/newsevents/speech/barr20231019a.htm>.

<sup>33</sup> See Global Market Shock and Large Counterparty Default Study (Washington, DC: Securities Industry and Financial Markets Association, 2019), 21 <https://www.sifma.org/wp-content/uploads/2019/09/SIFMA-GMS-LCD-Study-FINAL.pdf#page=21>.

<sup>34</sup> Michelle W. Bowman, Governor of the Federal Reserve Board, Joint Press Release, July 27, 2023, <https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230727.htm>.

Figure 3

Calibration of Risk Factor Shocks

Asset Class	Risk Factor	Fed GMS Shock	FRTB Shock <sup>1</sup>	Max Actual 6-Month Shock	Max 6-Month Start Date
Credit (IG) Spreads	BBB Corporate Bond Spread	443 bps	124 bps	294 bps	3/17/08
	MarkIt CDX IG	185 bps	120 bps	207 bps	3/20/08
	MarkIt iTraxx Europe (IG)	150 bps	110 bps	306 bps	3/17/08
Credit (HY) Spreads	MarkIt CDX HY	476 bps	147 bps	161 bps	11/20/08
	MarkIt iTraxx Crossover Index	428 bps	95 bps	135 bps	9/17/09
Equity Market Value	CAC 40 Index	-33%	-28%	-43%	11/21/08
	DAX 30 Index	-33%	-29%	-43%	3/3/09
	Dow Jones Industrial Average	-26%	-26%	-42%	3/6/09
	Eurostoxx 50 Index	-35%	-28%	-44%	3/6/09
	S&P 500 Index	-26%	-31%	-47%	3/9/09

<sup>1</sup>FRTB implied shock, with capital multiplier of 1.5 and respective liquidity horizon incorporated

## II. The Cost of Credit and Financial Intermediation to U.S. Companies Will Continue to Increase

We are concerned that elements of the NPRs will have materially adverse effects on the cost of credit and the provision of financial intermediation and risk management activities, which will impact businesses, pension funds, government and other entities that are already coping with a challenging operating environment. These costs may be passed through businesses on to consumers, resulting in higher transportation costs, increased home energy bills, reduced returns on retirement plans, higher food prices and so on. According to research by Morgan Stanley and Oliver Wyman, if implemented as proposed, the B3E NPR will reduce wholesale banking revenues by up to \$40 billion (or approximately 13%), half of which is expected to be picked up by non-banks. U.S. banking organizations will likely need to make up for this loss of revenue through higher pricing, lower returns to investors or by exiting certain activities altogether.<sup>35</sup>

As an example, each major component of the B3E NPR layers on additional costs for derivatives, which are crucial to businesses' ability to manage risk. These components include FRTB and CVA, both of which are completely additive to current requirements.<sup>36</sup> In addition, U.S. banking organizations capitalize derivative default risk under the Standardized Approach for Counterparty Credit Risk ("SA-CCR") and credit migration risk through the annual Comprehensive Capital Analysis and Review ("CCAR") exam. The following further describes the implications of FRTB, CVA and the treatment of SFTs under the B3E NPR, with examples of how these components of the B3E NPR would impact end-users.

**Impact of FRTB requirements:** We estimate more than half of the RWA increase associated with FRTB is driven by products often transacted with end-users as well as asset managers such as pension funds. These capital increases will be felt across the U.S. economy and by the U.S. public given the impact on retirement and retail investing, corporate hedging and mortgage financing; for example:

<sup>35</sup> Michael J. Cyprys et al., Into the Great Unknown, Global Banks & Asset Managers, (New York: Morgan Stanley Research & Oliver Wyman Insights, 2023), <https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2023/nov/Morgan-Stanley-Oliver-Wyman-Wholesale-Banking-Report-2023.pdf>.

<sup>36</sup> Operational risk-weighted assets represent the other component of the B3E NPR that is completely additive to current capital requirements and would also impact capital requirements associated with derivative transactions.

- Pension Funds: Pension funds that invest in bond and equity securities for average Americans and also hedge risk to these same securities will experience increased costs due to the FRTB's restriction on recognizing hedges between offsetting positions.
- Energy Companies: Power generators and utilities, including renewable energy companies, enter into transactions to hedge price fluctuations. Longer-dated contracts are generally less liquid and therefore are more heavily penalized under the FRTB. Higher costs to hedge price volatility may ultimately result in higher utility bills for the U.S. consumer.
- Mortgages: Agency mortgage-backed securities markets could be subjected to increased costs and decreased liquidity during periods of stress. The FRTB Standardized Approach ("FRTB SA") is punitive for mortgages and does not recognize credit or interest rate hedges. Moreover, during periods of stress, circumstances may preclude model use, further straining residential mortgage markets.
- Less Liquid Products: Overall market volatility will be exacerbated by the non-modellable risk factor ("NMRF") capital requirements in FRTB. For example, less liquid products will experience a decrease in market depth (i.e., willing buyers and sellers), making them even less liquid and risking a downward spiral. Volatility will also impact returns to investors, especially during times of less liquidity.

Impact of CVA requirements: The new CVA rule requires banking organizations to capitalize for the change in the price of a derivative due to the change in the creditworthiness of the counterparty. The resulting capital is entirely additive to existing requirements for derivatives as CVA currently only applies to Advanced Approach RWA. We estimate approximately 50% of the capital increase associated with CVA comes from collateralized transactions, primarily with asset managers such as pension funds and insurance companies. The remaining increase stems from uncollateralized transactions with end-users, which are specifically exempted from margin rules to avoid cost increases to U.S. businesses.<sup>37</sup> These transactions are disproportionately impacted, with capital required relative to trade notional being over ten times that for collateralized derivatives under SA-CCR. As a result of this treatment under CVA and RWA requirements for credit risk, U.S. corporations will experience higher costs and potentially more volatile revenues; for example:

- Costs will increase to manufacturers and companies for hedging commercial risks due to the inclusion of CVA charges for uncollateralized transactions. The cost of hedging risk associated with foreign revenues and expenses of international operations through long-dated foreign exchange derivatives will become so costly that companies may forgo hedging.
- Similarly, additive CVA charges will increase the cost of transportation, and ultimately U.S. commerce, by increasing the cost of hedging energy and other critical inputs for U.S. logistics companies and other corporations that rely on the movement of physical goods. These increased costs will likely be passed on to U.S. consumers.

Impact of SFT requirements: The securities lending market serves a critical role in the U.S. economy by improving market liquidity and enhancing price discovery. The B3E NPR as proposed would significantly impact the functioning of this market through the introduction of the SFT minimum haircut floors, which will have a knock-on impact on the returns of beneficiaries like retirees:

- Pension funds will no longer be able to engage in securities lending transactions, as the B3E NPR treats them as unsecured loans. Since pension funds use securities lending to fund distributions to retirees, they may have to resort to liquidating securities to obtain cash. Because distribution dates are generally known by other market participants, pension funds may realize lower values for those liquidations.

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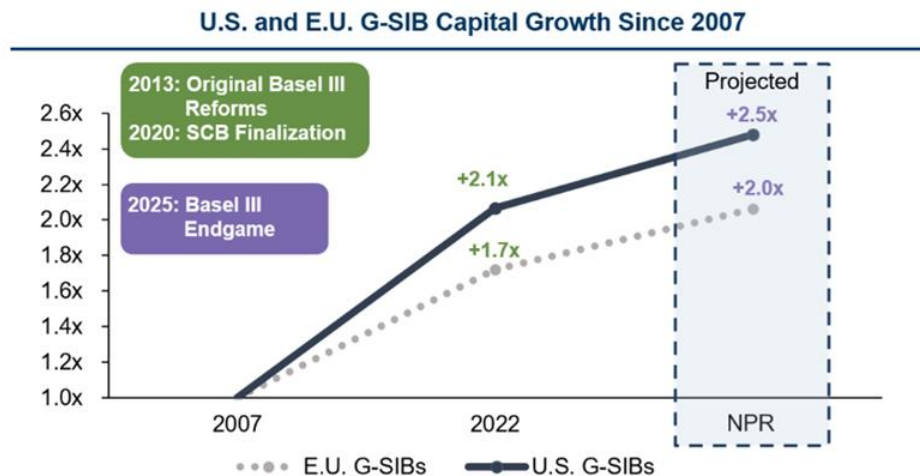
<sup>37</sup> See 7 U.S.C. § 2(h)(7)(A), (C); 17 CFR § 23.150(b)(1); 17 CFR § 240.18a-3(c)(1)(iii)(A).

- 401(k)s and other investment plans that use securities lending to generate additional returns may need to use alternative methods which will impact the returns passed on to beneficiaries.<sup>38</sup>

### III. Higher Capital Requirements Will Exacerbate the Shift of Credit and Market Intermediation to the Non-U.S. and Non-Bank Sector

As U.S. capital requirements are already some of the highest in the world, the NPRs place U.S. G-SIBs and other banking organizations at a competitive disadvantage to non-U.S. competitors and the non-bank sector. They also jeopardize the significant benefits that U.S. corporations, public pension funds, government-sponsored enterprises (“GSEs”) and municipalities enjoy by having the deepest and most liquid capital markets in the world. Research by Morgan Stanley and Oliver Wyman suggests that the B3E NPR will increase RWA associated with the existing U.S. wholesale banking industry by 35%, in contrast to a more modest increase of 15% in the E.U.<sup>39</sup> Figure 4 below shows that for E.U. G-SIBs the capital increase from implementing the E.U. version of the B3E international standards relative to 2007 capital levels (+2.0x) would be lower than the increase U.S. G-SIBs are subject to even before implementing the B3E NPR (+2.1x). This implies that the U.S. has already effectively implemented B3E from a capital stringency perspective, and that implementing the B3E NPR would only further exacerbate the unlevel playing field that exists in the current framework. Similarly, Figure 5 shows that U.S. G-SIBs would begin phasing in B3E requirements at 80% in 2025, a level that is higher than the 72.5% where E.U. G-SIBs will complete their phase-in in 2030. Specifically, U.S. G-SIBs begin phasing in at 80% in 2025, while E.U. G-SIBs complete phasing in at 72.5% in 2030. Without addressing these disparities, market liquidity in the U.S. will deteriorate relative to other jurisdictions, resulting in larger bid/offer spreads and reduced volumes of securities that can be bought or sold. Over the medium- to long-term, activity will continue to migrate to other jurisdictions.

Figure 4

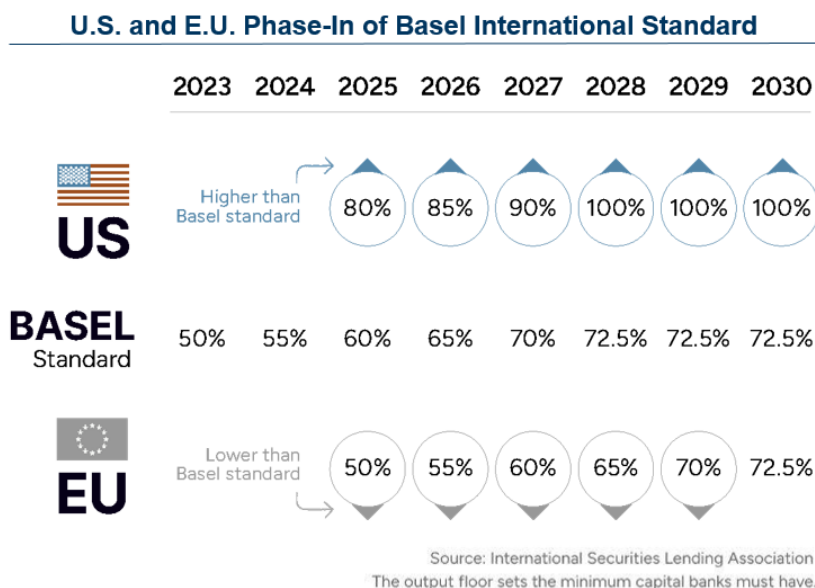


Source: FactSet, Common Equity of Publicly Traded G-SIB Bank Holding Companies

<sup>38</sup> California Public Employees’ Retirement System, Comment Letter on Proposed Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (December 22, 2023); American Benefits Council, Comment Letter on Proposed Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (January 16, 2024).

<sup>39</sup> Michael J. Cyprys et al., Into the Great Unknown, Global Banks & Asset Managers.

Figure 5



Current capital requirements have already placed certain markets under strain. Examples include the U.S. Treasury market at the onset of the COVID-19 pandemic in March 2020, the October 2014 flash crash and the September 2019 repo market pressures. During market turmoil, regulated banking organizations typically continue to make markets; however, they have become increasingly constrained by regulation (e.g., the inclusion of U.S. Treasuries in the Supplementary Leverage Ratio requirement). The NPRs will only exacerbate market disruptions and could require Congress or the Agencies to step in earlier to provide liquidity and relief to banking organizations to restore market order. In addition, the B3E NPR will reduce deployed capital in the system as banks conserve capital to avoid using buffers during times of stress. While the B3E NPR raises the absolute level of RWA across the system, it does not seriously address the issue of pro-cyclicality observed under current rules. The Global Investment Research team within Goldman Sachs analyzed the changes in U.S. G-SIB balance sheets during periods of market stress from 2020 to 2023 and determined that the U.S. G-SIBs were able to absorb a 10% to 15% increase in trading assets over this period.<sup>40</sup> Increasing required capital to levels indicated by the B3E NPR or our own estimates could make markets more fragile during periods of stress as banks will have more capital tied up in meeting regulatory requirements.

We agree with Governor Christopher Waller and other Federal Reserve governors that layering the NPRs onto the current regulatory capital framework will result in excessively onerous and complex capital requirements for U.S. G-SIBs,<sup>41</sup> increase rather than decrease divergence from other jurisdictions,<sup>42</sup> and

<sup>40</sup> Global Investment Research’s analysis relied on public data found in the U.S. G-SIBs’ annual FR Y-9C filings from 2019 to 2023.

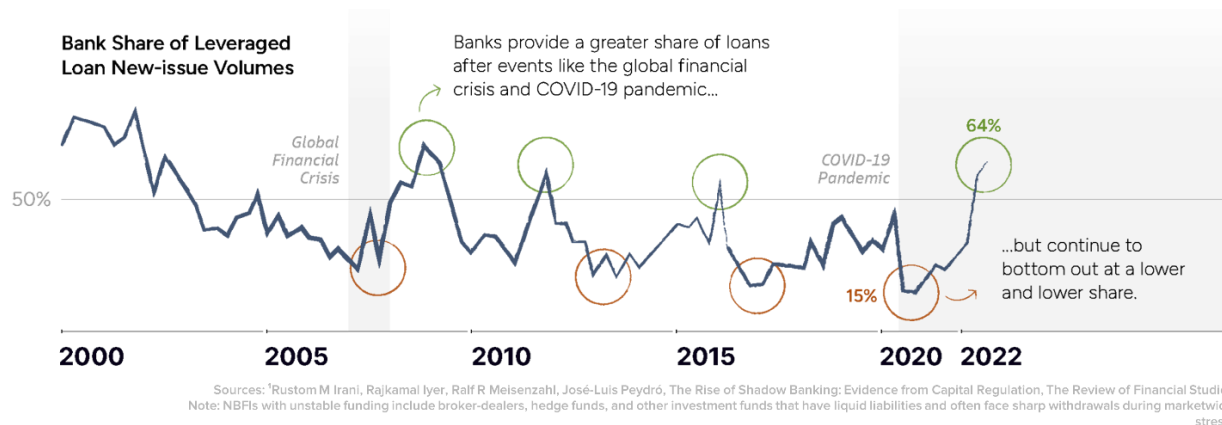
<sup>41</sup> See, e.g., Christopher J. Waller, Governor of the Federal Reserve Board, Joint Press Release, July 27, 2023. (“An important question... is why do banks need to sideline separate buckets of operational risk, credit risk, and market risk capital when those risks are unlikely to manifest at the same time? It is similar to asking individuals to establish separate emergency funds for shocks to their income, such as losing their job, and shocks to their expenses, like a fire in their house or their car breaking down. Households understand it is exceedingly unlikely that they will experience a month where all these shocks hit simultaneously so their emergency funds are less than the sum of those individual expected expenses.”).

<sup>42</sup> See, e.g., Michelle Bowman, Governor of the Federal Reserve Board, Joint Press Release, July 27, 2023 (“Today’s proposal deviates significantly from international standards and perpetuates differences in implementation across

result in core banking and capital markets activity migrating further to the less regulated non-bank financial sector. As Federal Reserve Chair Jerome Powell acknowledged in his statement during the open meeting to consider the B3E NPR, “raising capital requirements also increases the cost of, and reduces access to, credit. And the proposed very large increase in risk-weighted assets for market risk overall requires us to assess the risk that large U.S. banks could reduce their activities in this area, threatening a decline in liquidity in critical markets.”<sup>43</sup> The G30 Working Group on the 2023 Banking Crisis similarly warned that “the more tightly banks are regulated, the more activity will migrate into the unregulated financial sector. This could potentially make the overall financial system less safe, even as the shrunken banking part becomes safer.”<sup>44</sup>

The capital framework has already led to concentration and the migration of activities away from regulated banking organizations. Private equity and debt financing have both grown at annual rates of approximately 20% in North America,<sup>45</sup> which impacts the availability of credit as non-bank financial intermediaries (“NBFIs”) tend to reduce the provision of financing in market downturns,<sup>46</sup> requiring regulated banking organizations to step in to fill the gap. Figure 6 shows how regulated banking organizations step in to meet loan demand during market turmoil. However, the trend since 2008 would suggest that they do this at a diminishing rate as the share of leveraged lending in normal times provided by NBFIs has increased. Furthermore, a 2023 report by McKinsey & Company shows that between 2015 and 2022 in the United States, more than 75% of the growth in financial funds is accounted for by NBFIs.<sup>47</sup> This includes, among other things, sovereign wealth funds, private capital and retail assets under management.

Figure 6



international jurisdictions. Ultimately, these differences call into question whether the international standards are appropriate.”).

<sup>43</sup> Jerome Powell, Chair of the Federal Reserve, Joint Press Release, July 27, 2023.

<sup>44</sup> Bank Failures and Contagion, published by the G30 Working Group on the 2023 Banking Crisis, January 2024.

<sup>45</sup> Debopriyo Bhattacharyya et al., *The Global Banking Annual Review 2023: The Great Banking Transition* (New York: McKinsey & Company, 2023), 29, <https://www.mckinsey.com/industries/financial-services/our-insights/global-banking-annual-review>.

<sup>46</sup> A 2023 report by the Basel Committee found that non-banks cut lending by ~50% more than banks when faced with financial shock. Iñaki Aldasoro et al., *Non-bank lending during crises - BIS Working Papers No 1074* (Basel, Switzerland: Basel Committee on Banking Supervision, 2023), 2, <https://www.bis.org/publ/work1074.pdf>.

<sup>47</sup> Debopriyo Bhattacharyya et al., *The Global Banking Annual Review 2023: The Great Banking Transition*.

Total private-credit funds in the United States reached \$1.47 trillion in 2022, which is equivalent to over half of total business loans made by U.S. banks.<sup>48</sup> While private credit has provided alternative financing to certain growth sectors, particularly in a rising rates environment, NBFIs may adversely impact commercial access to credit if, for example, funds need to liquidate positions quickly in order to raise funding.<sup>49</sup> In fact, the FSOC annual report cited the rise in private credit from non-banks as “contributing to financial system vulnerabilities,” finding that “the level of opacity in private credit markets can make it challenging for regulators to assess the buildup of risks in the sector” and noting that “private credit is a relatively opaque segment of the broader financial market that warrants continued monitoring.”<sup>50</sup>

In terms of concentration, two NBFIs now account for approximately 50% of U.S. retail equity trading, which reduces competition.<sup>51</sup> This trend could increase vulnerability as the remainder of the market would have to absorb a large share of overall trading if either of the two largest participants were to suddenly exit. Central clearing, originally intended to reduce operational and counterparty risk associated with derivatives, is now concentrated in the hands of fewer dealers as capital requirements have made this low-margin activity less profitable.<sup>52</sup> The number of futures commission merchants (“FCMs”) in the United States that clear swaps have decreased from 22 to 12 since 2014, with 94% of activity concentrated in 7 FCMs.<sup>53</sup> Figure 7 shows the dramatic increase in the share of U.S. mortgage originations now accounted for by NBFIs. Between 2010 and 2022, the share has more than quintupled. This is a prime example of core banking activities migrating out of the regulated sector due to higher capital requirements. We are concerned that the effect is that consumers no longer face transparent, regulated banking organizations.

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<sup>48</sup> Matt Wirz, “The New Kings of Wall Street Aren’t the Banks. Private Funds Fuel Corporate America,” *Wall Street Journal*, October 8, 2023, <https://www.wsj.com/finance/fed-rate-hikes-lending-banks-hedge-funds-896cb20b>.

<sup>49</sup> *Ibid.* For a more in-depth discussion of the growing market share and risks of pushing an increasing share of the production of credit and other investments to the shadow banking system, see John Coates, *The Problem of Twelve: When a Few Financial Institutions Control Everything* (New York: Columbia Global Reports, 2023).

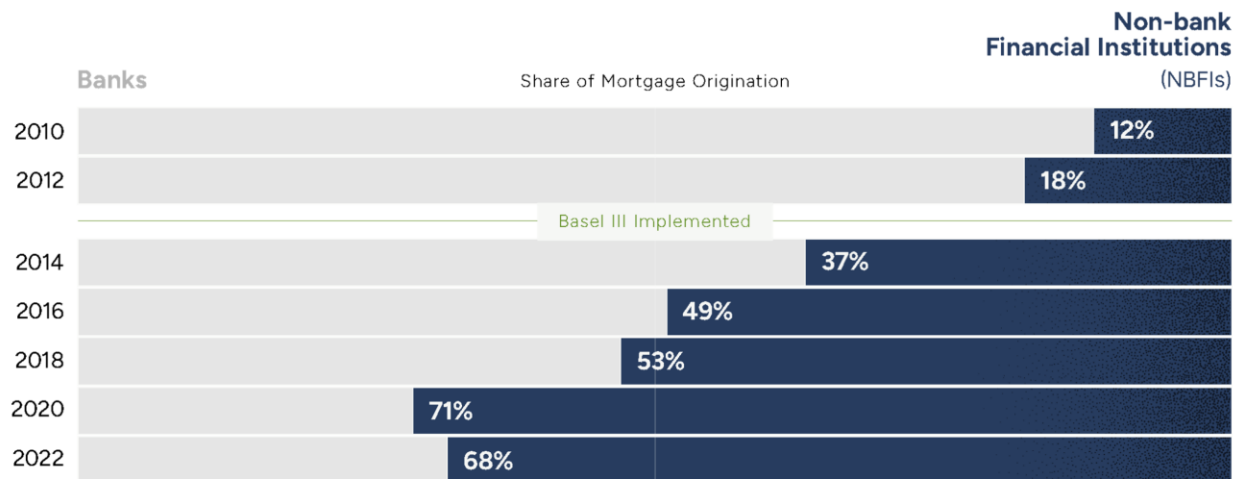
<sup>50</sup> *FSOC 2023 Annual Report*, prepared by the Financial Stability Oversight Committee (Washington, DC, 2023). <https://home.treasury.gov/system/files/261/FSOC2023AnnualReport.pdf>.

<sup>51</sup> Goldman, Sachs & Co. LLC analyzed U.S. retail equity trading data available through Bloomberg and determined that approximately 50% of U.S. retail equity trades are executed by two NBFIs. See also *Hearing on Game Stopped? Who Wins and Loses When Short Sellers, Social Media, and Retail Investors Collide, Part III, Before the House Committee on Financial Services*, 117th Cong. (2021) (Securities and Exchange Commission Chair Gary Gensler) (“The high concentration of retail orders routed to a small number of wholesalers raises a number of questions about market structure ... History and economics tell us that when markets are concentrated, those firms with the greatest market share tend to have the ability to profit from that concentration. Market concentration can also lead to fragility, deter healthy competition, and limit innovation.”), <https://www.sec.gov/news/testimony/gensler-testimony-20210505>; Securities and Exchange Commission Chair Gary Gensler, Statement on Proposal to Enhance Order Competition, December 14, 2022, <https://www.sec.gov/news/statement/gensler-order-competition-20221214>, (“[D]evelopments [in the] markets have resulted in a market structure that is less competitive, less transparent, and more concentrated than it should be for individual orders...Broker-dealers route more than 90% of marketable orders of individual investors in [National Market System] stocks to a small group of six off-exchange dealers, often referred to as ‘wholesalers.’”).

<sup>52</sup> Commodity Futures Trading Commission Chair Rostin Behnam, Keynote Remarks at the Federal Reserve Bank of Chicago’s Fifth Annual Conference on CCP Risk Management, October 16, 2018, <https://www.cftc.gov/PressRoom/SpeechesTestimony/opabehnam10>, (“[A] number of market participants have expressed concerns to me regarding FCM concentration and its effects on access to clearing. ...The statistics paint a very concerning picture...five firms, all bank-affiliated, account for over 80% of total client margin for cleared OTC derivatives in the United States, the United Kingdom and Japan. Many large bank-owned FCMs have exited the swaps clearing business citing as one reason the global introduction of the Basel Committee on Bank Supervision’s Basel III leverage ratio and the Supplementary Leverage Ratio (SLR) in the United States.”).

<sup>53</sup> Lukken, Walt, “Viewpoint - Disincentivizing Clearing: It’s Déjà vu All Over Again,” *FIA Market Voice, Futures Industry Association*, September 15, 2023, [www.fia.org/marketvoice/articles/viewpoint-disincentivizing-clearing-its-deja-vu-all-over-again](http://www.fia.org/marketvoice/articles/viewpoint-disincentivizing-clearing-its-deja-vu-all-over-again).

Figure 7



Source: Rustom M Irani, Rajkamal Iyer, Ralf R Meisenzahl, José-Luis Peydró, The Rise of Shadow Banking: Evidence from Capital Regulation, The Review of Financial Studies  
 Note: NBFIs with unstable funding include broker-dealers, hedge funds, and other investment funds that have liquid liabilities and often face sharp withdrawals during marketwide stress.

Bill Dudley, the former President of the Federal Reserve Bank of New York, observed that, “[r]ising costs will inevitably make banks less competitive relative to non-bank institutions such as private capital firms and alternative mortgage lenders. This should be cause for concern because the latter face much less regulation and often no capital requirements at all. In trying to strengthen banks, the U.S. could end up with a more fragile banking system.”<sup>54</sup> FDIC Chair Martin Gruenberg warned that “bank-like services operated outside the regulated banking environment can pose opaque risks and interconnectedness that could adversely affect the safety and soundness of banks or result in consumer harm.”<sup>55</sup>

Without more rigorous analysis of the NPRs’ potential impact on the U.S. economy and given the existing over-calibration of risks, we think it is important to approach such a comprehensive rewrite of the capital framework with an appropriate measure of caution. Otherwise, the punitive treatment of capital markets activities in the NPRs will further push activity overseas and outside of the regulated banking sector, without making the U.S. financial system safer. Research by Morgan Stanley and Oliver Wyman similarly concluded that, if implemented, the B3E NPR “...would naturally lead to share erosion in international markets, captured by non-US banks subject to less onerous requirements, and value migration out of the banking sector where products or services could be delivered by non-bank competitors (an acceleration of a value shift that began after the last major change in capital rules).”<sup>56</sup>

#### IV. The NPRs Are Not Supported by a Sufficient Level of Due Process

A decision to increase capital by the magnitude indicated by the NPRs must be preceded by a rigorous analysis of current data along with a robust cost-benefit analysis.<sup>57</sup> These analyses must be made available to the public through the Agencies’ customary rulemaking process, which includes a comment period, so that those stakeholders most impacted by B3E have ample time to respond. Even the Federal

<sup>54</sup> Bill Dudley, former President of the Federal Reserve Bank of New York, “Bigger Financial Cushions Won’t Solve Banks’ Woes,” Bloomberg, September 11, 2023.

<sup>55</sup> Martin J. Gruenberg, Chair of the FDIC, Remarks on the Financial Stability Risks of Nonbank Financial Institutions, Exchequer Club, (September 20, 2023).

<sup>56</sup> Michael J. Cyprys et al., Into the Great Unknown, Global Banks & Asset Managers, 13.

<sup>57</sup> Governor Michelle Bowman’s primary reason for voting against the Proposed Capital Rule was similarly that “there is insufficient evidence that the benefits produced by this proposal would justify the costs.” Michelle Bowman, Governor of the Federal Reserve Board, Joint Press Release, July 27, 2023.



Reserve acknowledges that the market risk components of the B3E NPR require additional study.<sup>58</sup> Although the Agencies intend to refine their estimates through an additional data collection, conclusions from this data must be made available for public comment.<sup>59</sup>

As noted earlier, the Agencies materially underestimated the B3E NPR's impact on the banking sector and the businesses and customers that are served because the estimates were based on data dated as of year-end 2021 and did not reflect G-SIB capital surcharge increases or the impact of the G-SIB NPR.<sup>60</sup> Instead of the 19% increase in capital that the Agencies estimated would result from the B3E NPR on the US G-SIBs, a quantitative impact study using data as of the second quarter of 2023 showed that the NPR is expected to increase capital in the aggregate for the U.S. G-SIBs by more than 30%, while increasing RWA by 33%.<sup>61</sup> As a number of trade associations have commented, "stakeholders cannot effectively comment on, and regulators cannot control for, these outcomes if the rule's basic assumptions are flawed."<sup>62</sup>

Without additional analysis and public consultation, it is difficult to understand how the Agencies concluded that such a drastic increase in capital requirements related to capital markets activity is necessary, or that the benefits outweigh the costs. At this point, there is overwhelming support among a cross-section of stakeholders for additional public deliberation before a final rule is contemplated.<sup>63</sup>

## Summary of Recommendations

For the reasons discussed above, the Agencies should re-propose the NPRs once sufficient study has been conducted and the detailed results of the Federal Reserve's recently proposed quantitative impact study have been published for review and comment by the public. If the Agencies choose not to do that, notwithstanding the due process questions raised by the NPRs, they should make the following changes to avoid the most damaging effects, with details on each recommendation in the Appendix of this letter:

- Do not add the SCB to the capital required by the B3E NPR. The final proposal should only add the fixed 2.5% component of the Capital Conservation Buffer to the B3E NPR's Expanded Risk-Based Approach ("ERBA") and should not add the variable and fluctuating SCB to ERBA. The SCB is a capital requirement that is only applicable in the United States and should therefore only apply to the U.S.-specific Standardized Approach. This methodology would recognize that while the Basel standard allows for a 72.5% standardized capital floor, the United States, based on the "Collins Amendment," effectively has a 100% floor.
- Do not implement the proposed SFT minimum haircut floor framework. SFTs are critical to the capital markets as they create liquidity in debt and equity securities markets and allow pension funds to manage their cash flows and distributions to beneficiaries and earn additional returns on behalf of retirees. The current SFT proposal, however, would prevent pension funds from making

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<sup>58</sup> 88 Fed. Reg. 64028, 64170-64171 ("The overall effect of higher capital requirements on market making activity and market liquidity remains a research question needing further study.").

<sup>59</sup> Michael S. Barr, Vice Chair for Supervision of the Federal Reserve Board, Joint Press Release, July 27, 2023 ("We also intend to collect additional data to refine our estimates of the rule's effects.").

<sup>60</sup> Financial Services Forum et al., Comment Letter on Proposed Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity.

<sup>61</sup> Ibid.

<sup>62</sup> Ibid. See also Bank Policy Institute et al., Request for Re-Proposal of Regulatory Capital Rule to Remedy Administrative Procedure Act Violations (September 12, 2023), <https://bpi.com/wp-content/uploads/2023/09/Letter-to-Agencies-Re-Missing-Information-2023.09.12-vF.pdf> ("Yet in support of these substantial new requirements, the proposed rule repeatedly relies on data and analyses that the agencies have not made available to the public.").

<sup>63</sup> Business Roundtable, Comment Letter on Proposed Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (December 21, 2024); National Association of Manufacturers, (January 10, 2024); Bank Policy Institute, Comment Letter on Proposed Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (January 12, 2024).

use of securities lending markets due to the cliff effect inherent in the minimum haircut floors. For this reason, no other major jurisdiction has implemented them. In fact, the European Banking Authority (“EBA”) noted in 2019 that “from a prudential perspective the minimum haircut floors framework if implemented in the capital framework as envisaged in the Basel standards could theoretically lead to a more risky situation for institutions than the status quo.”<sup>64</sup> If implemented, the Agencies should expand the types of transactions that are exempt from the SFT minimum haircut floors to include those with highly regulated counterparties, and should implement other fixes such as partial recognition of collateral for transactions below the minimum haircut floors and recognition of collateral that has been sent but not yet settled.

- Modify FRTB to correct critical design flaws and eliminate excessive capital requirements that result from the interplay of FRTB and the SCB. The Agencies should (i) ensure a credible path to Internal Model Approaches (“IMA”) by removing the Spearman Correlation metric of the Profit and Loss Attribution Test (“PLAT”) and avoid volatility by allowing for transient technical breaks in the PLAT, (ii) allow for the use of the IMA for the Default Risk Charge (“IMA-DRC”), which is consistent with the FRTB international standard, or address critical technical flaws associated with the Standardized Approach DRC (“SA-DRC”), and (iii) better recognize the benefit of portfolio diversification by recalibrating the supervisory “Rho” parameter that would otherwise limit those benefits. Without these modifications, banking organizations’ ability to manage certain risks, such as basis risk, on behalf of U.S. businesses will be greatly diminished and capital requirements will remain excessive.
- Modify the CVA framework to better reflect economic risk as well as accounting and risk management practices. The Agencies should exempt end-users from CVA, which is also consistent with the end-user exemption from the alpha factor in SA-CCR as well as the E.U. implementation of B3E. CVA risk weights should also differentiate between less regulated and highly regulated financial institutions as well as pension funds. In addition, the Agencies should address the over-calibration of CVA margin period of risk (“MPOR”) because derivatives are now subject to post-crisis margining requirements that result in margin generally being received well within a five-day period (as is recognized in the assumed holding period for client-facing collateralized derivatives in SA-CCR). The Agencies should also exempt client-cleared derivatives from CVA, consistent with how CVA is treated for accounting purposes as well as the U.K. and E.U. implementation of B3E. Finally, banking organizations should be permitted to compute Standardized Approach CVA (“SA-CVA”) counterparty credit risk capital by fully repricing under the rule-prescribed credit shocks to better reflect non-linearity. Failure to make these changes will harm U.S. businesses seeking to hedge legitimate commercial risk.
- Extend the 65% beneficial risk weight for investment grade (“IG”) debt to all IG companies with audited financial statements. The B3E NPR provides IG corporate exposures the benefit of a 65% risk weight, rather than 100%. To qualify for this benefit, the company must have a publicly traded security outstanding and must, in effect, be publicly listed. The Agencies should eliminate the public listing requirement, consistent with E.U. treatment. If this change is not made, a significant number of U.S. companies that are large private enterprises including pension funds, insurance companies and asset managers will be unjustifiably disadvantaged.
- Recalibrate the G-SIB NPR. With respect to the G-SIB NPR, the Agencies should recalibrate the coefficients for calculating Method 2 scores, which were based on U.S. data from 2012 and 2013, to account for economic growth in U.S. GDP since the rule was finalized in 2015. This change would be consistent with the Agencies’ stated intention in the final G-SIB surcharge rule and would ensure that economic growth does not unduly impact a banking organization’s systemic risk score. In addition, the Agencies should adjust the fixed conversion factor for short-term wholesale funding to ensure that the indicator represents only 20% of the total system risk score. Finally, on-balance

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<sup>64</sup> Policy Advice on the Basel III Reforms: Securities Financing Transaction, prepared by the European Banking Authority (La Défense, Paris, France, 2019), 43, <https://extranet.eba.europa.eu/sites/default/documents/files/documents/10180/2886865/870bbd5e-ae8f-4933-9f36-784c7183c7f4/Policy%20Advice%20on%20Basel%20III%20reforms%20-%20SFTs.pdf?retry=1>.

sheet items should only be reported on a no-more-than monthly, rather than daily, basis to reduce unnecessary operational burden.

Our detailed recommendations are contained in the appendix of this letter. They focus primarily on the capital markets-related elements of the B3E NPR – FRTB, CVA, and SFT requirements – and the interaction between the B3E NPR and other elements of the capital framework, particularly the Federal Reserve’s stress testing framework. The appendix also addresses several recommendations related to the G-SIB NPR.

Sincerely,

A handwritten signature in black ink, appearing to read "D. Coleman", written in a cursive style.

Denis Coleman

Chief Financial Officer

### Detailed Recommendations

We believe the following six main features of the NPRs should be amended when they are re-proposed to allow U.S. banking organizations to continue acting as a source of strength to the capital markets and enable U.S. businesses, consumers and state and local governments to competitively participate in the global economy. In addition, we recommend two modifications to the current capital framework to improve risk sensitivity.

#### **Recommendation 1: Reduce Over-calibration by Not Applying the SCB to ERBA Ratio Requirements**

One of the main drivers for the large, estimated increase in capital requirements applicable to U.S. banking organizations under the B3E NPR is the application of the SCB to ERBA ratio requirements. We believe that this represents an over-calibration of certain risks. For example, default credit risk is captured for RWA purposes through SA-CCR and reflected in stress capital requirements via the Large Counterparty Default (“LCD”) and other correlated defaults. As a result, the same potential risk of loss associated with the same counterparty is capitalized for twice. The integration of capital requirements from RWA calculations and projected losses arising from stressed conditions through the calculation of the SCB has not been contemplated together and is unique to the United States. This fact should therefore be considered when determining the calibration of binding risk-based capital ratios.

Recommendations to address these issues are as follows:

##### **1. Apply SCB only to Standardized Approach ratio requirements**

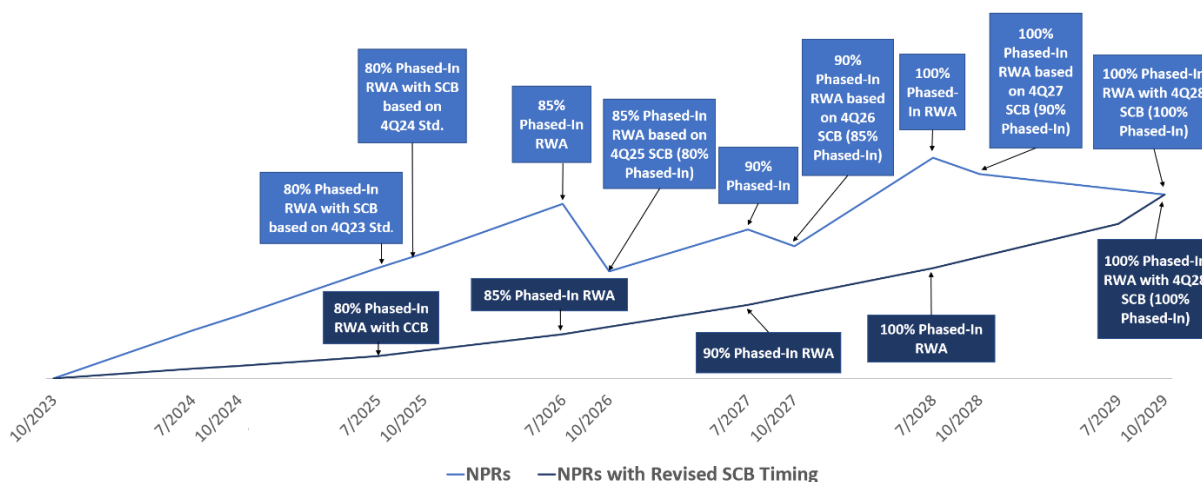
- Whether considering default credit risk, market risk, CVA or operational risk, there is clear evidence in the capital framework of the same risks being captured under both the RWA and stress capital frameworks. This represents a clear over-calibration of capital requirements, particularly when compared to other jurisdictions, which lack such an explicit stress capital requirement like the SCB that is part of capital ratio requirements. Unless the severity of the supervisory stress scenarios and assumptions are considerably reduced, the Agencies should modify the B3E NPR to apply the SCB buffer requirement only to the Standardized Approach ratio. Otherwise, risk weighting should only be applied to exposure amounts that are already reduced by losses incurred in the Federal Reserve’s hypothetical stress scenario.

##### **2. Address the SCB timing mismatch**

- The Agencies should address the mismatch in timing that results from the calculation of RWA under the proposed transition period, which starts on July 1 of each of the three transition-year periods, and the calculation of the then-relevant SCB, which is based on pre-July 1 RWA. The impact of this mismatch in timing is that an SCB requirement, based on a lower amount of RWA, comes into effect and is held against a higher amount of RWA. Capital requirements are therefore arbitrarily higher during the transition period than at the end of the transition period. It cannot be the policy intent for interim capital requirements to exceed terminal capital requirements. This can be avoided by waiting until the conclusion of the three-year transition period before applying the SCB to the ERBA ratio requirements. As seen in Figure 8, delaying the application of the SCB to ERBA ratio requirements reduces the volatility in required capital through October 2029, when the phase-in of ERBA RWA is fully reflected in the RWA calculation.

Figure 8

Required Capital Over Time



Recommendation 2: Do Not Implement SFT Minimum Haircut Floors

The Agencies should not implement the SFT minimum haircut floors as they impede the functioning of critical activities within the capital markets, such as reverse repurchase agreements, securities borrowing and margin loan transactions. In addition, the SFT minimum haircut floors are inconsistent with banking organizations’ core counterparty credit risk management practices for securities borrowing transactions. Banks determine economic haircuts for these transactions based on a number of factors, including counterparty type, purpose of the transaction as well as collateral provided or received. The SFT minimum haircut floors represent a blunt, risk-insensitive approach to counterparty credit risk. No other major jurisdiction has chosen to implement them. As noted earlier, the EBA stated in 2019 that “from a prudential perspective the minimum haircut floors framework if implemented in the capital framework as envisaged in the Basel standards could theoretically lead to a more risky situation for institutions than the status quo.”<sup>65</sup> Both the E.U. and U.K have chosen not to implement the framework to date, and instead to monitor the SFT market to see if future consideration is appropriate. In fact, there is no major jurisdiction that has chosen to implement this part of the international standard. Implementation will therefore make the United States an outlier relative to international peers.

SFT activity is important for price discovery as well as supplying efficiency and liquidity for stocks, U.S. Treasuries and other major asset classes. Entities with large pools of securities like pension funds and exchange traded funds will lend securities to banking organizations. Banking organizations will pay a fee and provide collateral to borrow those securities. Those fees are passed on to pension beneficiaries or savers through augmented returns or reduced fees. The typical securities lender is therefore not part of the shadow banking sector, the financing of which was the original target of the Financial Stability Board’s introduction of the SFT minimum haircut floors.<sup>66</sup> As a result, the SFT minimum haircut floors fail to achieve their stated purpose of reducing leverage in the non-bank sector.

<sup>65</sup> Policy Advice on the Basel III Reforms: Securities Financing Transaction, prepared by the European Banking Authority (La Défense, Paris, France, 2019), 43, <https://extranet.eba.europa.eu/sites/default/documents/files/documents/10180/2886865/870bbd5e-ae8f-4933-9f36-784c7183c7f4/Policy%20Advice%20on%20Basel%20III%20reforms%20-%20SFTs.pdf?retry=1>.

<sup>66</sup> Financial Stability Board, Transforming Shadow Banking into Resilient Market-based Finance (Basel, Switzerland: Financial Stability Board, 2015), <https://www.fsb.org/wp-content/uploads/P070920-1.pdf> (“The regulatory framework for

Banks, on the other hand, borrow these securities for a specific purpose, such as covering client short positions. It is broadly understood that securities borrowing transactions are generally “purpose transactions” as opposed to “funding transactions” (i.e., a bank is sourcing a security for a specific purpose rather than to provide cash to the security lender). Securities lenders typically require banking organizations to overcollateralize the loans they receive, evidencing the fact that these loans are driven by the borrower’s needs. This over-collateralization, which is in fact required by the Securities Exchange Act (“SEA”) Rule 15c3-3 for U.S. broker-dealers (i.e., a broker-dealer must provide collateral representing at least 100 percent of what it has borrowed), means that such transactions must inherently fail any minimum haircut requirement imposed on banking organizations unless they are appropriately exempted from the framework altogether. Figure 9 depicts how compliance with both regulations simultaneously would be impossible. Figure 10 then provides the capital consequences of the unavoidable non-compliance with the SFT minimum haircut floors.

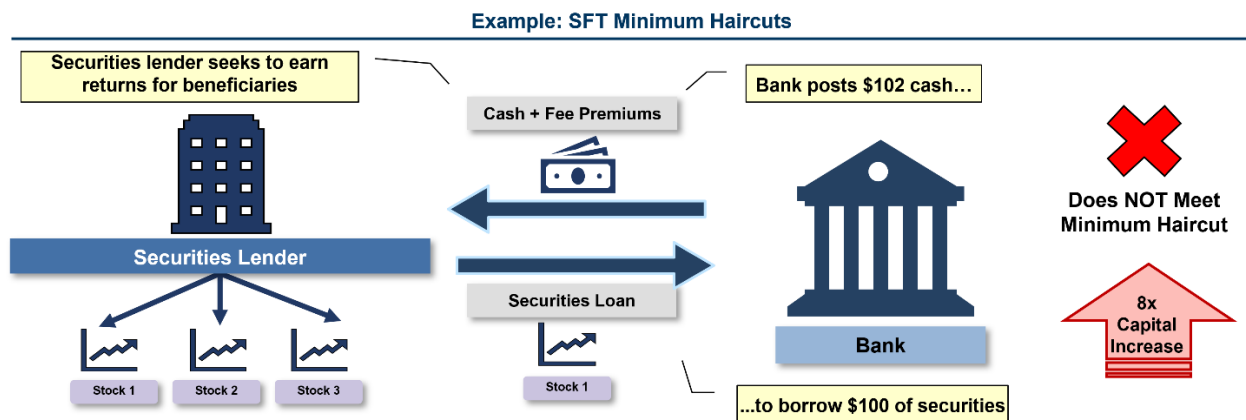
Figure 9

**SFT Minimum Haircut & Reg T / 15c3-3 Interaction**

	Compliance with Reg T / 15c3-3	Compliance with SFT Minimum Haircut
Bank Provides Collateral Haircut	Pass	Fail
Bank Receives Collateral Haircut	Fail	Pass

The SFT minimum haircut framework creates a scenario where a bank cannot both pass Reg T / 15c3-3 and recognize collateral

Figure 10



The Federal Reserve already recognizes a distinction between cash financing from a broker-dealer and securities loans to the broker-dealer in its Regulation T. This regulation applies minimum haircuts (or margin requirements) for cash margin loans, recognizing that where a broker-dealer is borrowing securities for “the purpose of making delivery of the securities in the case of short sales, failure to receive securities required to be delivered, or other similar situations,”<sup>67</sup> such transactions are not in scope for margin requirements. Further, there are other regulatory limitations on the amount of leverage that banking

haircuts on non-centrally cleared securities financing transactions is intended to limit the build-up of excessive leverage outside the banking system, and to help reduce procyclicality of that leverage.”)

<sup>67</sup> 12 CFR 220.10(a).

organizations and broker-dealers may transmit through the financial system, for example, through the Financial Industry Regulatory Authority (“FINRA”) Rule 4210.

Given these safety provisions are already in place in U.S. funding markets, the SFT minimum haircut floor framework is an unnecessarily blunt, over-calibrated and ineffective tool to limit leverage to the non-bank sector. Additionally, paragraph 179 of the international Basel Framework contemplates the presence of local rules and regulations that restrict certain transactions made inconsistent with the SFT minimum haircut floor framework as a legitimate reason for forgoing their implementation.<sup>68</sup> Not implementing the SFT minimum haircut floor framework in the United States is therefore consistent with the spirit of paragraph 179. For the above reasons, the Agencies should not implement this portion of the international Basel Framework; however, if the SFT minimum haircut floor framework is included in the final rule, it should be amended in the following ways:

#### **1. Expand the types of transactions exempted from SFT minimum haircut floors**

- The B3E NPR provides exemptions from the minimum haircut floors that, in principle, exclude the types of SFTs that do not result in leverage to the shadow banking sector. It is imperative, however, that the exemptions be implemented in ways that do not impose unnecessary burden or make the exemptions otherwise impractical to apply. Specifically, the B3E NPR should clarify that:
  - The exemption allowing for transactions where the counterparty provides representations that it has reinvested the cash at the same or a shorter maturity than the maturity of the original transaction<sup>69</sup> (“the reinvestment requirement”) should be expanded to permit all transactions where the cash has been reinvested in securities with minimal liquidity risk, such as U.S. Treasury and agency securities, overnight repo, certificates of deposit, commercial paper, and the like.
  - Relatedly, in response to Question 55 of the B3E NPR, in-scope transactions for the SFT minimum haircut floors should not include transactions for which sovereign exposures are provided as collateral. Such a provision would reduce market liquidity for U.S. Treasuries as the funding of these securities would become more expensive. If the Agencies take a more stringent approach with respect to sovereign exposures than the U.K. and/or E.U., the perverse situation would be created in which the U.S. government must rely on foreign banks to create a requisite level of liquidity in, for example, U.S. Treasuries, such that it does not affect the primary issuance market.
  - Similarly, transactions in which debt securities issued by a GSE (e.g., Freddie Mac, Fannie Mae, etc.) are provided as collateral should also be excluded from in-scope transactions.
  - The reinvestment requirement should permit the borrower to rely on representations from the lender (or its agent) that its cash collateral reinvestment guidelines (rather than on a transaction-by-transaction basis) meet the exception’s criteria. This will recognize that agent lenders often invest cash collateral on a pooled basis across beneficial owners and that borrowers do not have direct visibility into the reinvestment portfolios of the lenders.
  - The exemption for purpose SFTs<sup>70</sup> should follow the structure of Regulation T, which already serves to distinguish securities loans from cash financing. In particular, the exemption should clarify that the SFT minimum haircut floors do not apply to transactions where the borrowing banking organization reasonably anticipates need for the securities, such as for settlement or delivery obligations; custodial possession, control, or safekeeping requirements; or upcoming securities loans it is making. In addition, the final rule should

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<sup>68</sup> Basel Committee on Banking Supervision, CRE Calculation of RWA for credit risk, CRE 56.1 (effective as of January 1, 2023).

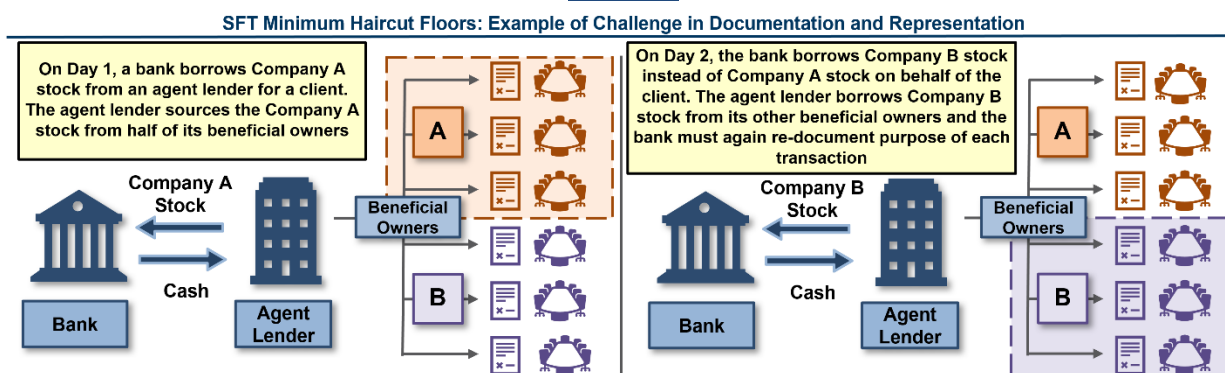
<sup>69</sup> See B3E NPR, §\_\_.121(d)(2)(ii)(A).

<sup>70</sup> Ibid.

clarify that the framework does not apply to transactions where the banking organization is a foreign entity (or is borrowing to relend to a foreign entity) that is borrowing a foreign security for any lawful purpose. This is consistent with Regulation T and also reflects the goal of leveling the playing field for foreign subsidiaries of U.S. banking organizations (as competitors who are not subsidiaries of U.S. banking organizations will be able to borrow without the imposition of SFT minimum haircut floors).

- o Further, the use of the term “sufficient written documentation” in the purpose exemption should be clarified that it does not require documentation on a transaction-by-transaction basis. Rather, whether or not the banking organization has a “permitted purpose” for borrowing securities should be determined at an aggregate, entity level. Banking organizations already have governance and compliance processes in place to determine for purposes of Regulation T whether or not it has a permitted purpose, which should be relied on as well for SFT minimum haircut floor compliance. Figure 11 depicts the complexity of documenting each individual repurchase agreement transaction.

Figure 11



**2. Exclude highly regulated counterparties, such as open-ended mutual funds, mutual insurance companies, pension funds, or registered investment companies<sup>71</sup> from the definition of “unregulated financial institution”**

- The definition of “unregulated financial institution” is a financial institution that is not a regulated financial institution, including any financial institution that meets the existing definition of “financial institution” except for the ownership thresholds contained in paragraph 4(i) of the definition. This definition is unclear in two respects: first, the use of the word “including” implies that an entity might be an unregulated financial institution even if it does not otherwise meet the definition of “financial institution”; second, it is unclear whether an entity that is exempt from the existing definition of “financial institution” – such as a registered investment company or its foreign equivalent, or an employee benefit plan as defined under relevant provisions of ERISA – or other regulated entities that are subject to limitations on their leverage is similarly exempt from the definition of “unregulated financial institution.” We therefore recommend that the definition be limited to an entity that (1) meets the definition of “financial institution”, (2) is not among the list of regulated entities in paragraphs (1) – (3) or among the list of exempted entities

<sup>71</sup> These types of highly regulated counterparties are listed in the B3E NPR in Question #39: “For what reasons, if any, should the agencies consider applying a lower risk weight than 100 percent to exposures to companies that are not publicly traded but are companies that are ‘highly regulated?’ What, if any, criteria should the agencies consider to identify companies that are ‘highly regulated?’ Alternatively, what are the advantages and disadvantages of assigning lower risk weights to highly regulated entities (such as open-ended mutual funds, mutual insurance companies, pension funds, or registered investment companies)?” 88 Fed. Reg. 64028, 64054 (Question 39).



in paragraph (7) of the existing definition of “financial institution”,<sup>72</sup> and (3) is not otherwise subject to regulation in the United States or outside the United States, such as with respect to limitations on its use of leverage. Such a modified definition ensures that the definition is properly targeted to entities that are not already subject to prudential regulation.

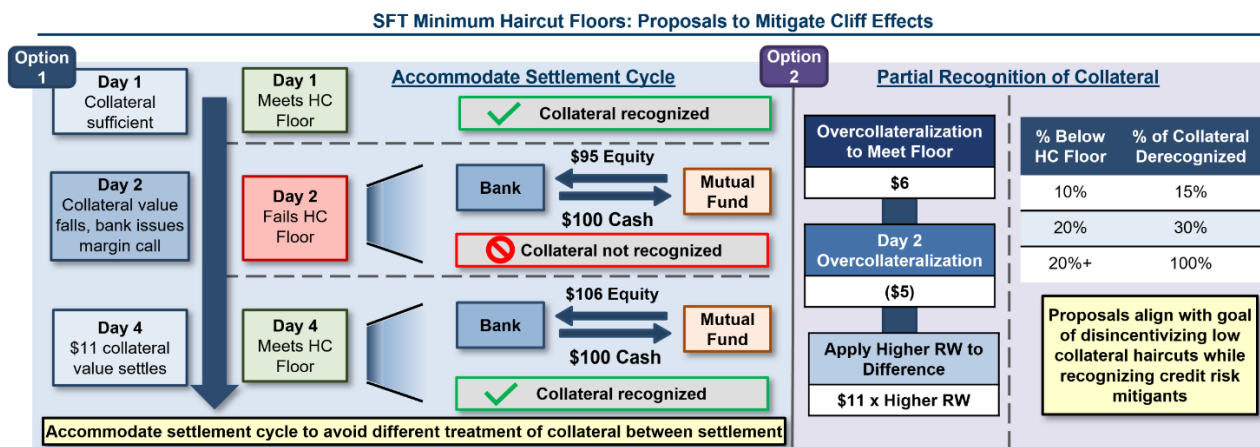
In the absence of making the above distinction with respect to the definition of an “unregulated financial institution,” the Agencies should explicitly exempt “highly regulated counterparties,” such as open-ended mutual funds, mutual insurance companies, pension funds, or registered investment companies.

### 3. Implement alternative options to avoid cliff effects

- **Option 1: Accommodate settlement cycle:** The Agencies should allow banks subject to the SFT minimum haircut floors to consider collateral that has been called but not yet settled. Disregarding collateral that has not yet settled, only to recognize it one or two days later after it has settled, creates undue volatility in meeting the SFT minimum haircut floor requirements.
- **Option 2: Partial recognition of collateral:** If the Agencies retain SFT minimum haircut floors, they should only impose incrementally higher risk weights on net exposures in excess of the SFT minimum haircut floors; for example, the net exposure in excess of the SFT minimum haircut floor receives a risk weight of two times the normal risk weight for that counterparty. Alternatively, the Agencies should adopt a progressively more stringent percentage of collateral that may not be recognized, e.g., derecognizing 15% of collateral if it is up to 10% below the SFT minimum haircut floor, 30% if it is up to 20% below the SFT minimum haircut floor, and so on, until there is a complete derecognition when the gap is too wide. Both of these solutions are consistent with the goal of disincentivizing collateral haircuts that are too low, while recognizing the reality that the transactions are, in fact, secured by collateral, even if not to the same extent as required by the B3E NPR.

Figure 12 illustrates the importance of accommodating the settlement cycle in the minimum SFT minimum haircut floor framework as well as how applying a higher risk weight to the net exposure in excess of the SFT minimum haircut floor or partially recognizing collateral would function.

Figure 12



<sup>72</sup> 12 CFR § 217.2 (definition of “financial institution”).

### Recommendation 3: Address Key FRTB Calibration Flaws

Although the B3E NPR provides a more coherent way of measuring market risk when compared to the current value-at-risk (“VaR”) methodology, the Agencies should address certain critical flaws within FRTB highlighted below and ensure that it is calibrated appropriately versus the GMS. While we support the models-based expected shortfall approach in the FRTB as a more stable measure of tail risk, the B3E NPR heavily penalizes short-term operational breaks in model testing, diverges from sound risk management by penalizing prudent hedging, fails to properly capture the benefits of diversification, and is not sufficiently risk sensitive. In the re-proposal, the Agencies should address the following:

#### 1. IMA eligibility

- **Improve the stability of capital metrics:** The Spearman Correlation metric should not be binding in determining ongoing eligibility for an IMA desk. Rather, the Spearman Correlation metric should be used as a qualitative check on how well models are performing, complementing the other binding measures (Kolmogorov-Smirnov (“KS”) metric, VaR back-testing) prescribed in the B3E NPR. Spearman is sensitive to minor inconsistencies in data, making it unreliable, and small outliers can disqualify desks that should otherwise be permitted to use IMA, including some of the most vanilla, liquid markets such as U.S. Agencies. In addition to being a barrier for IMA eligibility, having unreliable metrics at the foundation of PLAT will create volatility in market risk capital requirements that will be difficult for banks to manage. As a qualitative check on model performance, the Spearman Correlation metric will still provide banking organizations and regulators with valuable information, without unduly disqualifying otherwise robust models.
- **Exempt certain technical break exceptions:** The PLAT should be enhanced to recognize valid one-off reasons for failures. In particular, technical causes of breaks should be discounted, consistent with their current treatment in the back-testing framework. Even with a high degree of accuracy in data creation and transfer, the number of data points involved in closing a trading book each day may result in temporary or one-off data inconsistencies. Treating these technical adjustments as breaks does not reflect the ability of banks to properly model risk and overemphasizes less pertinent aspects of a bank’s model. Particularly in cases where a model requires only minor remediation, the prolonged effect of a PLAT failure is overly burdensome. The PLAT requirements should therefore be enhanced to exclude technical one-off adjustments.
- **Provide for an eligibility cure period:** In order to avoid capital cliff effects of moving from IMA to SA as a result of a PLAT failure, the final rule should allow for a “cure period.” Provided a banking organization demonstrates in a timely manner (e.g., 60 days), and to the satisfaction of the supervisor(s), that issues causing breaks in either Risk Theoretical P&L (“RTPL”) and/or Hypothetical P&L (“HPL”) have been remediated, the banking organization should be permitted to ignore breaks during the remediation process. This would help to avoid unnecessary volatility in a banking organization’s capital requirements.

#### 2. Standardized risk insensitivity

In line with the international Basel standards, the Agencies should allow the use of IMA for measuring FRTB DRC. The requirement to use SA-DRC is a risk-insensitive approach and fails to appropriately recognize hedging with models that are rigorously tested. In the absence of allowing the use of IMA, the Agencies should address the following technical deficiencies:

- **SA-DRC hedge recognition**
  - **Expand maturity alignment:** The B3E NPR allows banks to assign the same maturity to a cash equity position as the maturity of the derivative contract it hedges, permitting full offset, and similarly allows for maturity matching of a derivative hedge with the underlying instrument when the instrument can be delivered into the derivative contract. The proposal’s maturity alignment provisions should be extended to derivative versus derivative

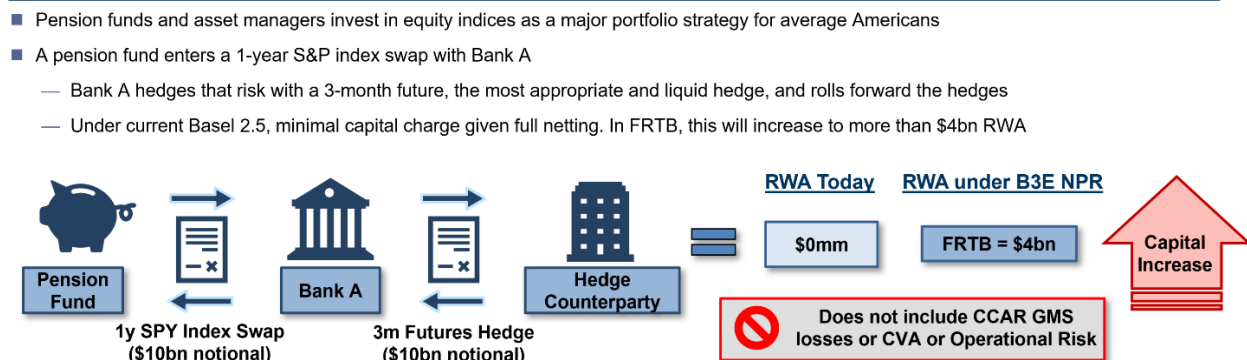
transactions, which will allow for better hedge recognition in SA-DRC given the B3E NPR has deviated from the Basel rule and disallowed the use of models for default risk capital requirements. Derivative transactions are generally more liquid than cash equity transactions. The absence of appropriate hedge recognition for derivative versus derivative transactions will potentially increase the cost of hedging activities and/or result in the use of less efficient hedges (e.g., cash equity hedges) which unduly increases funding costs and introduces additional risks (e.g., dividend risk).

- **Recognize optional early termination (“OET”) clauses for derivatives:** In addition to expanding maturity alignment for derivative versus derivatives transactions, the B3E NPR should recognize OET clauses that allow the bank to retain optionality to exit a long position at an earlier date than the contractual maturity. For equity swaps, the notification period to exercise an OET clause represents an implied maturity, which creates an effective maturity match with the underlying equity. In the absence of OET recognition, banking organizations will seek less efficient hedges. OET clauses are an efficient and safe solution for a market risk framework that assumes derivative hedges cannot be replaced once they mature. If OET is not recognized, banking organizations should be permitted to apply the maturity scaling afforded to other market risk covered positions with maturities of one year or less.

Figure 13 provides an example of derecognizing liquid hedges in the SA-DRC calculation and the implications for capital requirements.

*Figure 13*

**Example: Hedge Recognition in SA-DRC**



- **SA-DRC risk sensitivity / calibration**

- **Recognize “issuance” rather than “issuer” rating for sovereign debt:** The FRTB SA calculation does not appropriately recognize the differences in credit ratings between sovereign debt denominated in local currencies versus foreign currencies. Sovereign debt that is denominated in the sovereign’s local currency generally receives a more favorable credit rating than sovereign debt denominated in nonlocal (foreign) currency due to the sovereign issuer’s ability to make payments in local currency. The FRTB SA as proposed would assign a risk weight solely based on a sovereign issuer’s rating, rather than on the rating of each individual sovereign issuance, which carry different risk profiles. Recognizing the reduced risk associated with local currency-denominated sovereign debt would improve the risk sensitivity of the FRTB SA calculation. It would also enhance consistency across U.S. regulatory frameworks, including most notably CCAR, where the Federal Reserve prescribes different shocks to issuances of sovereign debt denominated in different currencies. Additionally, the ERBA, as well as the existing Standardized

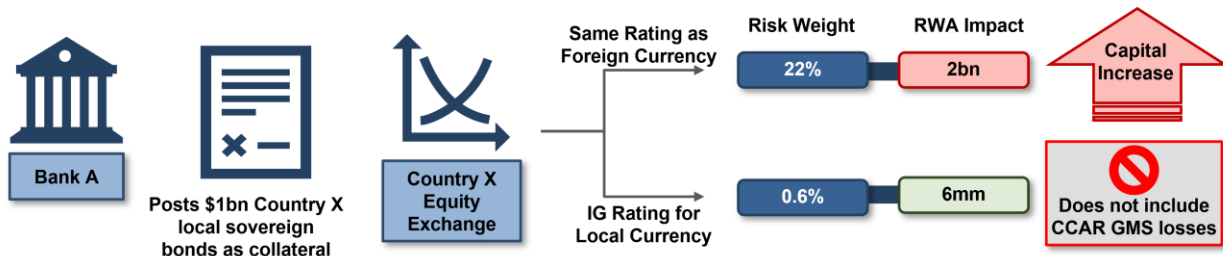
Approach, allow for a more favorable treatment of the credit risk of non-U.S. sovereign exposures denominated in the sovereign’s own currency.

Figure 14 shows the capital impact assuming FRTB SA disallows the use of credit ratings on an issuance-by-issuance basis for sovereign debt and instead assigns a risk weight solely based on the sovereign issuer’s rating.

*Figure 14*

**Example: Non-U.S. Sovereigns in SA-DRC**

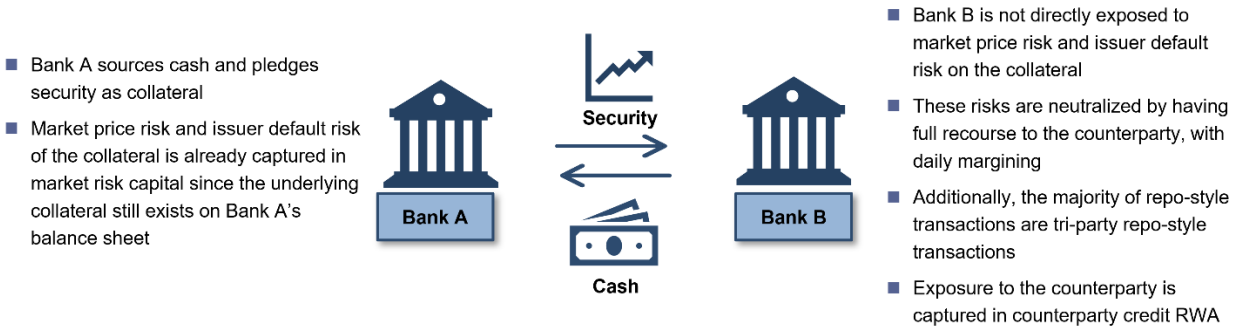
- As part of client facilitation, a bank holds \$1bn of Country X, local denominated currency bonds as collateral at Country X’s local equity exchange
- Such non-risk-taking position is penalized under the B3E NPR despite the local exchange having these bonds as preferred collateral



- **Ensure appropriate capital allocation across correlation trading portfolio (“CTP”) structures:** The decomposition approach prescribed by the B3E NPR results in equity tranches attracting considerably less capital than senior and super senior tranches, which is counterintuitive as it is the equity tranches that first sustain losses. The Agencies should ensure the decomposition approach preserves the risk profile of the structure, with proportionally more capital allocated to bottom-most tranches. Specifically, we recommend the following principles as the basis for an economically sound capital allocation: (1) Capital for the full structure should be equivalent to that of the untranched index the structure replicates; (2) For each tranche, capital should not exceed its max loss and should appropriately recognize hedges; and (3) The risk profile of the tranches relative to one another should be preserved.
- **Remove the requirement within Standardized Approach Sensitivities-based Method (“SA-SbM”) or DRC RWA on capitalizing the collateral leg of term repo-style transactions:** The B3E NPR introduces a new treatment for term repo-style transactions that banks elect as market risk covered positions, which requires capture of market price risk and issuer default risk of the collateral. This does not align with the economic risk profile of the transaction. The market price risk of repo-style transactions to the cash lender is incurred through interest rate and repo spreads. The cash-lending bank does not face direct market price risk or issuer default risk on the collateral, as it remains on the balance sheet of the cash borrower. Additionally, the majority of repo-style transactions are tri-party repo-style transactions, which by function of being centrally cleared carry less systemic and counterparty risk. The contingent counterparty exposure is capitalized under Counterparty Credit Risk RWA. Banks should not be required to calculate SA-SbM or DRC RWA on the collateral leg of a term-repo style transaction. Adoption of the proposed treatment will overly penalize term repo-style transactions, which will have adverse effects on the liquidity of securities markets. Figure 15 provides more detail on the risk and economics of term repo-style transactions.

Figure 15

Example: Treatment of Term Repo-Style Transactions



• **SA - hedge recognition for securitized products**

- **Recognize credit hedges in credit spread risk (“CSR”) securitization non-CTP:** Credit products are used to hedge the credit spread risk of mortgages, given the correlation between them and the fact that mortgage derivatives are less liquid. In FRTB SA-SbM, mortgages are capitalized through CSR securitizations (non-CTP) and credit hedges are capitalized through CSR non-securitizations, with hedges currently additive to RWA due to no diversification. Continuing to hedge, for prudent risk management, will increase the capital costs of market-making in mortgage bonds for various clients (e.g., pension funds), which will have adverse effects on the liquidity of these markets. Additionally, this disincentivizes hedging mortgage inventory and can lead to poor risk management. Similar to recognizing hedges for securitization CTP exposures, we recommend allowing recognition of the credit hedges for securitization non-CTP exposures (e.g., introduce an inter-risk class correlation parameter).

**3. IMA risk sensitivity**

- **Extend the zero-correlation assumption to all asset classes:** Under the FRTB, risk factors that do not pass the risk factor eligibility test are deemed to be less liquid and, consequently, are subject to a conservative treatment under the NMRF framework. The current treatment of NMRFs incorporates multiple layers of conservatism, from considerably longer liquidity horizons to no recognition of diversification across product categories. In addition, the NMRF framework contains a regulatory parameter, Rho, which specifies a fixed correlation across risk factors within each product category. Rho is calibrated such that NMRFs are presumed to be highly correlated, considerably limiting diversification and resulting in punitive capital charges. This calibration is at odds with the express presumption that only idiosyncratic (i.e., uncorrelated) risk factors remain in the NMRF framework, with the NPR explicitly allowing NMRFs to be decomposed into their systematic and idiosyncratic components (with only the latter subject to the NMRF charge). This internal disconnect exacerbates the already conservative treatment of less liquid risks and may, ultimately, disincentivize banks from applying for IMA. The Agencies should ensure the final rule is internally consistent and extend the zero-correlation assumption currently applied to credit and equity NMRFs to all asset classes, allowing for appropriate recognition of diversification.

#### 4. FRTB – internal risk transfer (“IRT”)

The FRTB introduces new requirements around IRTs, which are transfers of credit risk, interest rate risk, or CVA risk from the banking book, or a CVA desk, to a trading desk using internal derivatives. The requirements set forth in the B3E NPR create operational burdens and do not align with how banks manage these types of positions, specifically as it relates to CVA risk.

- **Remove IRT externalization requirements for certain internal CVA hedges and permit more flexibility for external hedge recognition for default risk:** If an IRT of CVA risk is subject to curvature risk, default risk or the residual risk add-on under the market risk capital requirement, the B3E NPR requires that an external transaction be executed with a third party that is identical in its terms to risk transferred from the CVA desk to the trading desk. Executing identical external hedges on a one-to-one basis may not be feasible, particularly for market hedges, given hedging is done on a portfolio basis and sourcing identical offsetting trades may not be possible. Particularly with cleared transactions, it is not practicable to match cleared transactions with specific internal hedges due to netting, compression, and related operational clearing processes. Additionally, this requirement may increase the complexity and the costs of hedging, as banks often use internal desks to concentrate and net off risks so that more efficient external hedging can be executed.

The Agencies should remove the externalization requirement for internal CVA hedges that are subject to curvature risk or the residual risk add-on, but maintain the externalization requirement for default risk, consistent with non-CVA hedges. Additionally, for default risk, the B3E NPR should permit more flexibility for recognition with external hedges (i.e., partial recognition for maturity and/or counterparty mismatches). If externalization is retained for market hedges, banks should be permitted to recognize internal CVA hedges as eligible CVA hedges as long as the bank demonstrates, to the satisfaction of its federal supervisor(s), that it has an effective risk management and monitoring system in place to manage its CVA risk.

- **Do not require IRT documentation at a transaction level:** In order to qualify as an IRT and recognize the mitigating benefits of internal hedges, the B3E NPR requires banks to document, on a transaction-by-transaction basis, the underlying exposure being hedged and its sources of risk, whether credit risk, interest rate, or CVA risk. This documentation requirement at a transaction level is impractical. Banking organizations often hedge their CVA risk on a portfolio basis to enhance efficiency and reduce costs, making it very difficult operationally to map portfolio-level internal hedges back to specific trades.

The agencies should modify the documentation requirement by mandating documentation on a portfolio basis or on desk basis (i.e., something similar to a trading and hedging strategy). Alternatively, the B3E NPR should allow for IRT documentation on a product basis as opposed to an individual transaction basis.

#### **Recommendation 4: Address Key CVA Framework Flaws**

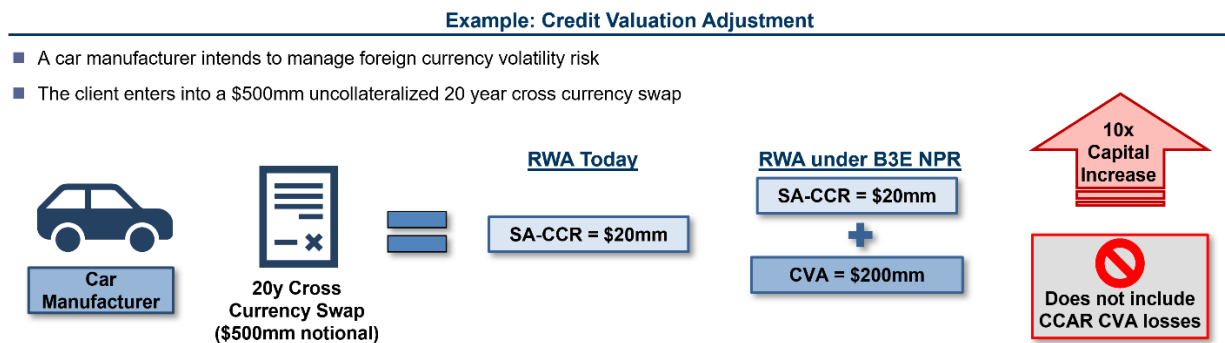
The Agencies should recalibrate the CVA framework to avoid capitalizing for the same risks in both the CVA framework and CVA included within the GMS. Failing to do so will pose serious challenges for U.S. businesses and other end-users that rely on banks to hedge their commercial risk by imposing higher costs and limiting options within the derivatives market. The ability of end-users to hedge risks efficiently and effectively is a stabilizing force within the economy; for example, manufacturers that can use commodity derivatives to hedge against the volatility of raw materials are less likely to dramatically change prices in response to increases in the cost of raw materials. Similarly, pension plans use derivatives to protect their portfolios against market moves and ensure a safe stream of income for U.S. retirees. To reduce the negative impact on end-users, the Agencies should address the following shortcomings within the CVA framework:

**1. Exempt transactions with end-users and highly regulated financial institutions and their associated hedges from CVA risk**

- End-users<sup>73</sup> should be excluded from CVA risk to align with other congressionally mandated and exemptions adopted by the Commodity Futures Trading Commission<sup>74</sup> for end-users' hedging activities and to incentivize the use of prudent hedging for legitimate commercial risk. The importance of end-user hedging was previously recognized through congressional exemptions in the uncleared swap margin rules for swap dealers and security-based swap dealers. Similarly, the Agencies exempted end-users in SA-CCR from the application of an "Alpha" supervisory factor of 1.4, which increases the capital required for derivative calculations. A failure to provide for an end-user exemption runs counter to these legislative and regulatory efforts. Further exempting derivatives with end-users from CVA risk does not result in holding zero capital against these trades since they are included in stress testing and counterparty credit risk capital requirements (i.e., through SA-CCR).

Derivative transactions with end-users are often uncollateralized as end-users typically do not have access to large pools of liquidity to post as margin. As a result, the capital a bank currently must hold for the credit risk against, for example, an uncollateralized foreign exchange swap to help a corporate manage its currency risk increases by over ten times under the B3E NPR relative to the amount of capital a banking organization must hold today under SA-CCR (see Figure 16 below). This, in turn, substantially increases the cost of hedging for end-users which will lead to higher prices for American consumers or reduce innovation as corporations will be forced to spend more on hedging instead of reinvestment. It will also result in counterparties choosing not to hedge, ultimately increasing risks throughout the economy. For this reason, the E.U. exempts end-users from CVA. Failure to provide for a similar exemption in the United States, places U.S banking organizations at a competitive disadvantage and may result in activities moving overseas.

*Figure 16*



- Pension funds and insurers should also be exempted from CVA so as not to unduly penalize the hedging of their unique risks. Pension funds and insurers provide an essential function to

<sup>73</sup> See 12 CFR § 217.2 (definition of "commercial end-user"). A commercial end-user is generally any entity that is using derivative contracts to hedge or mitigate commercial risk.

<sup>74</sup> Commodity Futures Trading Commission, *End-User Exception to the Clearing Requirement for Swaps*, 77 Fed. Reg. 42560 (July 19, 2012), <https://www.federalregister.gov/documents/2012/07/19/2012-17291/end-user-exception-to-the-clearing-requirement-for-swaps#:~:text=Congress%20promulgated%20the%20end%2Duser,transportation%2C%20or%20other%20commercial%20activities.>

Americans by helping them prepare for retirement and by providing protection from adverse events. Pension funds and insurers are exposed to interest rate and inflation risk due to the long-dated nature of their liabilities, which they manage by entering long-dated interest rate and inflation derivatives. This is critical to their ability to meet obligations to beneficiaries. Under the proposed CVA framework, pension funds and insurers are particularly penalized. Further, banking organizations generally hold very little or no CVA risk for these exposures as pension funds and insurers are highly regulated and subject to mandatory daily margining. An exemption for pension funds, insurers and other regulated financial end-users should be applied consistent with their exemption from the “Alpha” multiplier in calculating SA-CCR.<sup>75</sup>

- As it relates to the bucketing of financial institutions, the proposed risk weights for CVA should distinguish between highly regulated<sup>76</sup> and unregulated counterparties. For example, the supervisory risk weights for the CVA counterparty credit risk sensitivities are 5% for all IG financial institutions and 12% for all non-IG financial institutions. The Agencies should also recognize the difference in CVA risk between highly regulated and unregulated financial institutions for both IG and non-IG financial institutions. Accordingly, we recommend highly regulated IG and non-IG financial institutions receive 3% and 8.5% risk weights, respectively. These risk weights are calibrated to the highest risk weights of the “corporate” category. Unregulated IG and non-IG financial institutions should continue to receive 5% and 12% risk weights respectively. In addition, pension fund risk weights should not be higher than the fund’s corporate parent, in recognition that a pension fund has access to secured assets and is guaranteed by the parent. These changes improve the risk sensitivity of the framework and appropriately recognize the lower risk associated with regulated financial institutions compared to unregulated financial institutions.<sup>77</sup>

### 3. Recalibrate MPOR to industry standards

- A five-business day MPOR is sufficiently conservative in the CVA framework and consistent with MPOR under SA-CCR. The B3E NPR prescribes a five-business day floor for client-facing derivative transactions<sup>78</sup> and a ten-business day floor for all other CVA risk covered positions. The ten-business day floor for MPOR is more conservative than the industry’s current accounting practices as banks typically use a minimum MPOR of between zero and five business days. Post-crisis margining requirements for derivatives, including uncleared margin rules that broadly require the posting of initial margin (“IM”) and T+1 variation margining (with limited exceptions for end-users) have meaningfully reduced banks’ gap risk to within one day. If a client has not posted margin after one business day, they are no longer considered to be performing on their contractual obligations and therefore are in default. This close-out risk is already captured under SA-CCR. Finally, research suggests that a ten-business day MPOR is no longer relevant for uncleared derivative transactions as banking organizations are able to unwind or replace derivatives with defaulted counterparties within two to four days.<sup>79</sup>

A ten-business day MPOR is overly conservative and could increase systemic risk, as banking organizations will be incentivized to put on incremental hedges to reduce their CVA RWA, even

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<sup>75</sup> Note that in the E.U., insurers are exempt from both CVA as well as the Alpha multiplier under SA-CCR.

<sup>76</sup> A “highly regulated counterparty” is consistent with the definition used under Recommendation #2 for SFT minimum haircut floors, and includes open-ended mutual funds, mutual insurance companies, pension funds, or registered investment companies.

<sup>77</sup> International Swaps and Derivatives Association, Comment Letter on Proposed Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (January 16, 2024), <https://www.isda.org/a/rDIgE/ISDA-and-SIFMA-Response-to-US-Basel-III-NPR.pdf>

<sup>78</sup> See B3E NPR, §\_\_.113(i)(4)(i)(B)(2).

<sup>79</sup> Rama Cont, Margin Requirements for Non-cleared Derivatives (London, UK: International Swaps and Derivatives Association, 2018), <https://www.isda.org/a/Gz9EE/Margin-Requirements-for-Noncleared-Derivatives.pdf>.



though there is no actual risk. Hedging to reduce RWA (as opposed to economic risk) results in banking organizations taking on one-sided risk and, ultimately, earnings volatility.

#### **4. Exclude client-cleared derivatives from CVA**

- The Agencies should exclude client-facing exposures on a cleared trade from CVA risk capital requirements. Where a bank acts as a clearing member on behalf of clients, the banking organization retains no CVA risk and is only subject to default risk. As the intention of regulatory capital is to ensure banks are capitalized for potential loss and there are no CVA-associated losses for client-cleared derivatives, there should be no CVA capital requirement on these transactions. This is also consistent with the B3E NPR's exemption of SFTs and cleared derivative transactions from CVA on the basis that there is no CVA exposure for these transactions either. It also aligns with the broader policy goal to incentivize clearing, given the significant financial stability benefits it provides to the economy. For these reasons, E.U. and U.K. regulators have exempted client-facing derivative transactions from CVA capital requirements.<sup>80</sup>

#### **5. Allow banks to fully reprice SA-CVA counterparty credit risk**

- For the counterparty credit delta capital component of SA-CVA, banks should be permitted to fully reprice counterparty credit risk under the regulatory prescribed credit spread shocks represented in Table 1 to § \_\_.222 Supervisory Risk Weights,  $RW_C$  of the B3E NPR.<sup>81</sup> Under the B3E NPR, banks are required to calculate the change in CVA risk for a prescribed movement in credit spreads based on the credit quality and industry classification of the derivative counterparty. This calculation is done in two steps, which leads to an overstatement of the risk. As an example, for a derivative facing a high-yield ("HY") financial institution, banks must first compute the change in CVA risk for a 1bp shift in credit spread of the financial counterparty and then scale it by the prescribed RW of 12% to calculate the impact of a 1,200bps shift in credit spreads for a HY financial counterparty. This two-step methodology overstates the capital because of the non-linearity of the CVA counterparty credit risk. Instead of applying this two-step methodology, banks should be permitted to calculate the change in CVA risk directly for the prescribed credit-spread movement, which in the above example is 12% by shocking the spreads directly by 1,200bps. Allowing banks to fully reprice CVA risk based on the prescribed counterparty credit shocks would more accurately capture the counterparty credit risk in SA-CVA and would be more consistent with banking organizations' internal CVA risk management.

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<sup>80</sup> Prudential Regulation Authority, CP16/22 – Implementation of the Basel 3.1 standards: Credit valuation adjustment and counterparty credit risk (published November 30, 2022), 7.12, <https://www.bankofengland.co.uk/prudential-regulation/publication/2022/november/implementation-of-the-basel-3-1-standards/credit-valuation-adjustment>, ("The PRA proposes to retain the existing CRR exemption from CVA capital requirements for client clearing transactions, given that the PRA considers their risk to be low due to high levels of collateralisation, and the broader systemic benefits of clearing."). And: European Banking Authority, Capital Requirements Regulation (CRR), Part 3, Title VI, Article 382.3, <https://www.eba.europa.eu/regulation-and-policy/single-rulebook/interactive-single-rulebook/15937>.

<sup>81</sup> 88 Fed. Reg. 64028, 64156.

- Figure 17 demonstrates how conservative the calibration is under the B3E NPR using an example of a fully collateralized \$500mm 30-year USD interest rate swap with a speculative grade pension fund that currently has a 50-bps credit spread. Under the B3E NPR, banks would calculate the counterparty spread sensitivity to a one-bp shock, which equates to \$4.7k per bp. Banks would then apply the 12% supervisory risk weight for speculative grade financials resulting in an RWA charge of \$70mm [ $\$4.7k \times 1,200\text{bps} \times 12.5$ ]. However, if a bank fully reprices the CVA counterparty credit risk by applying a credit-spread widening of 1,200bps, the RWA charge would be \$24mm.

*Figure 17*

	Counterparty Credit Risk with 1 bp shock	Full repricing of CVA	Counterparty Credit Risk with risk-weight shock
50bps Credit Spread	4.7\$/k/bp	250\$/k	
1,250bps Credit Spread		2.15\$/mm	1.6\$/k/bp
RWA Calculation	$4.7k \times 1200\text{bps} \times 12.5 = 70\text{mm}$	$1.9\text{mm} \times 12.5 = 24\text{mm}$	$1.6k \times 1200\text{bps} \times 12.5 = 24\text{mm}$

As illustrated by Figure 17, the calculation under the B3E NPR materially overstates the counterparty credit risk. To improve the risk sensitivity of the calculation and capture non-linearity, we propose permitting banks to perform a full CVA repricing for the counterparty credit risk component of SA-CVA, or allow banks to compute counterparty credit risk based on the risk weight shocks.

### **Recommendation 5: Amend the Public Listing Requirement for IG Risk Weight**

The public listing requirement for IG entities to receive a 65% risk weight should be eliminated, similar to the U.K. and E.U. As proposed, the requirement will unduly raise the cost of borrowing for privately owned companies, as the new rules deem them riskier than their public counterparts. There are only ~4,000 publicly listed companies in the United States, a figure that has trended downward as forms of and a preference for private investment have grown.<sup>82</sup> In the United States, there is a predominance of privately held companies, in addition to mutual funds and pension funds that will potentially face higher costs if the B3E NPR is not amended. This outcome is particularly perverse for pension funds of publicly listed corporations, which will face a higher risk weight than their corporate parent even though they have access to secured assets and benefit from guarantees from the parent entity.

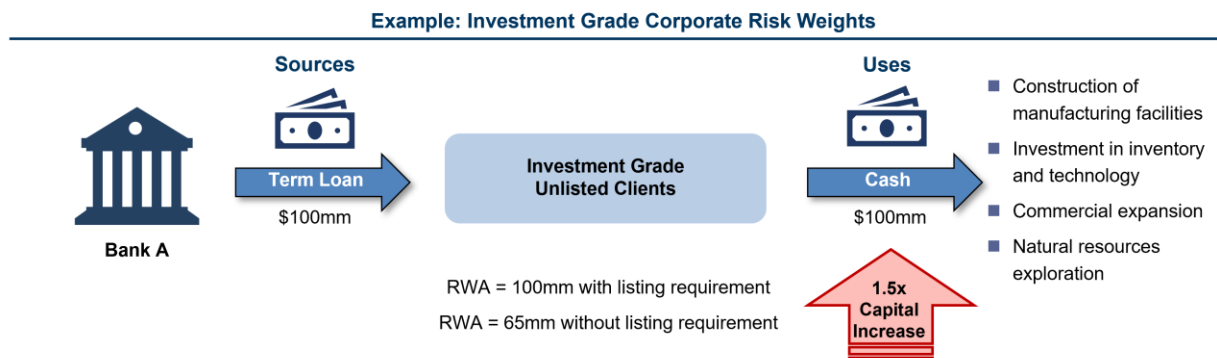
There are, however, other means by which to determine if an entity is sufficiently creditworthy to receive a lower risk weight relative to general corporates. For example, banks' internal ratings are subject to robust risk management and supervisory oversight. Banks' experience and empirical evidence suggest that internal ratings for unlisted corporates are equally as accurate as those for their listed equivalents. Furthermore, public exchanges like NASDAQ and NYSE do not have creditworthiness as a listing requirement, suggesting that while the listing requirement may be an imperfect proxy, it certainly should not be the sole one.

In place of the public listing requirement, the Agencies should recognize companies that have audited financial statements made available to banking organizations. Entities such as mutual funds and pension funds have public disclosures as robust as those of publicly listed companies in terms of being able to assess their creditworthiness. Many private companies must undergo audits and provide disclosures to receive loan financing, which are conducted according to the American Institute of Certified Public

<sup>82</sup> Nicole Goodkind, "America has lost half its public companies since the 1990s. Here's why," CNN Business, June 9, 2023, <https://www.cnn.com/2023/06/09/investing/premarket-stocks-trading/index.html>.

Accountants (“AICPA”) standards or of those of an equivalent national body with membership in the International Federation of Accountants (“IFAC”). These typically include standards on fair value, auditing and attestation, peer review and ethics prepared under Generally Accepted Accounting Principles (“GAAP”). Disclosures provided in accordance with widely accepted standards that lending institutions commonly rely on to provide financing should be sufficient to also determine whether a company is IG. Figure 18 shows the capital impact on a corporate loan that fails to meet the public-listing requirement.

Figure 18



### Recommendation 6: Revise the G-SIB Surcharge to Address Over-calibration Driven by Economic Growth and Short-Term Wholesale Funding

The G-SIB NPR does not address several ways in which the Agencies have over-calibrated the U.S. G-SIB surcharge, including by not updating it to account for economic growth over time. We recommend modifying the G-SIB surcharge provisions of the U.S. capital rules as follows:

#### 1. Adjust the coefficients for growth in GDP

The Federal Reserve should recalibrate indicator coefficients to account for growth in U.S. GDP, which the Federal Reserve said it would do in the G-SIB final rule.<sup>83</sup> Since 2012, U.S. G-SIB balance sheets have grown substantially, in line with U.S. GDP growth. The current GDP coefficient in the Method 2 G-SIB Surcharge framework requires firms to increase their capital for systemic risks as if their balance sheets had grown independently of the approximately 70% U.S. GDP growth since 2012. A banking organization’s G-SIB score is supposed to represent an individualized measure of that firm’s systemic footprint and its systemic risk relative to other firms. The extent to which a firm has grown in line with the growth of U.S. GDP represents nothing more than a reflection of the overall growth of the U.S. economy, and there is no justification for penalizing a banking organization for only keeping pace with U.S. economic growth.

#### 2. Adjust the short-term wholesale funding (“STWF”) indicator to constitute only 20% of the systemic risk score

The fixed conversion factor for STWF should be recalibrated so that the indicator is roughly 20% of a firm’s system risk score, consistent with the Federal Reserve’s initial intent that each of the five indicators for Method 2 be roughly of equal weighting. With the current fixed conversion factor at 350, STWF constitutes approximately 30% of firms’ overall scores, which has been the

<sup>83</sup> Board of Governors of the Federal Reserve System, *Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies*, 80 Fed. Reg. 49082, 49085 (August 14, 2015) (“The Board will periodically reevaluate the framework to ensure that factors unrelated to systemic risk do not have an unintended effect on a bank holding company’s systemic indicator scores.”).

case since firms began reporting data in 4Q16. This is likely due to the use of imperfect data in the initial calibration of the factor, which should be mitigated through an adjustment of the fixed factor.

**3. Do not include client-cleared derivatives in the Interconnectedness and Complexity indicators**

The G-SIB NPR should not include in the interconnectedness and complexity indicators client-cleared derivatives when the banking organization is performing in an agency capacity, which is already captured under the size indicator as well as under SA-CCR, CVA and in the amount of a clearing member's contribution to a central counterparty ("CCP") default fund and associated default fund. Tripling their capture under the G-SIB framework contradicts the Federal Reserve's reasoning not to include these transactions in the interconnectedness and complexity indicators as proposed in a separate proposal from 2017.

At that time, the Federal Reserve intended to capture the agency model of client clearing to ensure equal treatment with the principal model. However, after observing that the majority of clearing members clear on behalf of clients through the agency model, and almost all have the ability to do so, the Federal Reserve noted that equal treatment was no longer necessary. Nothing has changed over the last seven years that suggests that revisiting this conclusion is warranted. There is also nothing to suggest over the previous seven years that these extremely low-risk transactions should attract an even higher capital charge.

Furthermore, this requirement and the resulting additional capital requirements are at cross-purposes with the congressional mandate after the GFC to improve and increase the use of derivatives clearing. In fact, these mandates were an attempt to reduce complexity in the derivatives market by creating a CCP that nets clearing members' exposure to one another on a multilateral basis and in a safe and efficient way. Central counterparties reduce complexity by increasing standardization, improving transparency and managing the default risk of their members. Arbitrarily increasing capital requirements on these transactions will result in less clearing and exacerbate the decade-long trend of consolidation among clearing members.

**4. Require no more than monthly, rather than daily, averaging of on-balance sheet components**

On-balance sheet components of G-SIB indicators should be averaged on a no-more-than monthly basis to reduce operational burden and align with the frequency of derived components. As proposed, the G-SIB NPR introduces significant operational burden by requiring daily averaging while less-frequent averaging adequately addresses the issues of banks altering their balance sheets at quarter- or year-end to optimize their systemic risk profile. Certain derived components are not reported on a daily basis; for example, the Country Exposure Report, from which several reporting items are derived including foreign derivative claims, is filed on a quarterly basis. Daily reporting will prevent banking organizations from using inputs from the Country Exposure Report, further increasing operational burden associated with the G-SIB NPR. Monthly averaging allows firms to strike an appropriate balance between a risk-sensitive approach to the calculation of their G-SIB scores while relieving much of the associated operational burden.

**Recommendation 7: Amend the Current Capital Framework**

In addition to the six recommendations above to address key deficiencies of the NPRs, Goldman Sachs recommends making the following amendments to the current capital rules:

**1. Directly-issued credit-linked notes should be treated as credit risk mitigants for synthetic securitizations**

The B3E NPR should clarify within the current capital framework that directly-issued credit-linked notes ("CLNs") qualify as credit risk mitigants for synthetic securitization exposures. CLNs are a common and effective tool to help banking organizations mitigate their credit risk for securitization exposures. If a CLN meets the appropriate criteria, a banking organization may reduce the RWAs that it holds against the relevant securitization exposure. The Federal Reserve

stated in its recent FAQs<sup>84</sup> that banking organizations may recognize credit risk mitigation for a CLN that is issued indirectly by a special purpose vehicle if the CLN meets certain operational criteria<sup>85</sup> and meets the definition of a synthetic securitization exposure.<sup>86</sup>

At the same time, the Federal Reserve stated that directly-issued CLNs are unlikely to meet these requirements and are therefore unlikely to qualify as credit risk mitigants.<sup>87</sup> Synthetic securitization exposures require a transfer of credit risk through a guarantee or credit derivative. To qualify as a credit derivative, a transaction must be issued under standard industry credit derivative documentation. Although directly-issued CLNs include industry-standard credit default terms, they are not generally executed under standard industry credit derivative documentation. In addition, financial collateral meets the operational criteria for synthetic securitization exposures, but the Federal Reserve does not recognize the cash proceeds of a CLN as financial collateral because the banking organization does not hold the cash on deposit for the CLN investors.

The Federal Reserve in its FAQs expressed that it is willing to exercise a Reservation of Authority for directly-issued CLNs under the appropriate circumstances because a directly-issued CLN can be equally effective at transferring credit risk to CLN investors as an indirect CLN.<sup>88</sup> The Agencies should codify this point in the B3E proposal and provide certainty to the market that directly-issued CLNs will be recognized as credit derivatives and credit risk mitigants for synthetic securitization exposures.

## **2. Pledged collateral should not attract RWA for counterparty credit risk**

For repo-style transactions and eligible margin loans, if a banking organization pledges collateral to a third-party custodial account which is bankruptcy remote from the counterparty (i.e., does not transfer the title of the securities to the counterparty), the banking organization should not have to calculate RWAs for counterparty credit risk. Pledged collateral that is held in a bankruptcy-remote manner would not generally become part of a counterparty's assets in bankruptcy and thus would generally remain the property of the banking organization. Just as the current capital rules for cleared transactions do not include collateral posted to a CCP in a bankruptcy-remote manner as part of a banking organization's trade exposure amount to the CCP, pledged collateral held in a bankruptcy-remote manner should similarly be excluded from the exposure amount to a counterparty under the counterparty credit risk provisions for repo-style transactions and eligible margin loans.

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<sup>84</sup> Board of Governors of the Federal Reserve System, *Frequently Asked Questions about Regulation Q, Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks* (September 28, 2023), <https://www.federalreserve.gov/supervisionreg/legalinterpretations/reg-q-frequently-asked-questions.htm>.






<sup>85</sup> 12 C.F.R. § 217.41 or § 217.141.

<sup>86</sup> 12 C.F.R. § 217.2.

<sup>87</sup> Board of Governors of the Federal Reserve System, *Frequently Asked Questions about Regulation Q, Capital Adequacy of Bank Holding Companies, Savings and Loan Holding Companies, and State Member Banks*.

<sup>88</sup> *Ibid.*

B3E Differences Across Jurisdictions

	Basel Committee					
<b>Model Use-Credit Risk</b>	Retains use of models for credit risk	Models removed for credit risk	Retains use of models for credit risk	Retains use of models for credit risk	Retains use of models for credit risk	Retains use of models for credit risk
<b>SFTs</b>	Implements minimum haircut floor	Haircut floors implemented Carve out for stock borrows	Not implemented	Not implemented	Not implemented	Not implemented
<b>Credit Risk</b>	Counterparties must have publicly listed securities to receive lower RW for IG	Public listing required	Public listing not required	Public listing not required	Public listing not required	Public listing requirement waived if annual sales > CAD 75mm
<b>Derivatives</b>	Gross-up all SA-CCR exposure 40%	No gross-up for commercial end-users	No gross-up for all counterparties in the output floor	No gross-up for commercial end users & pension funds	Gross-up all SA-CCR exposure by 40%	Gross-up all SA-CCR exposure by 40%
<b>CVA</b>	Introduces revised CVA with less granular risk weights and no exemptions	No end-user exemptions No risk weight granularity	End-user exemptions for CVA	More granular risk weights for financials	No end-user exemptions	No end-user exemptions
<b>Operational Risk</b>	Firms must calculate a Standardized operational risk requirement	ILM floored at 1	ILM set to 1	ILM set to 1	ILM set to 1 if BI is <JPY 100bn	ILM implemented
<b>Securitization</b>	P factor increase from 0.5 to 1	P factor set to 1	P factor set at 0.25/0.5 based on structure	P factor set to 1	P factor set to 1	P factor set to 1
<b>G-SIB</b>	Method 1 implemented Cleared derivatives excluded	Gold-plated via Method 2 Cleared derivatives included	Method 1 only Cleared derivatives excluded	Method 1 only Cleared derivatives excluded	Method 1 only Cleared derivatives excluded	Method 1 only Cleared derivatives excluded
<b>Equity</b>	400% RW for speculative unlisted equity	400% RW for all unlisted equity	400% RW for short term venture capital	400% RW for venture capital	400% RW for speculative unlisted equity	400% RW for speculative unlisted equity
<b>Credit Risk-Residential Real Estate</b>	20% to 70% for non-rental property 30% to 105% for rental properties	40% to 90% for non-rental property 50% to 125% for rental properties	20% to 70% for non-rental property 30% to 105% for rental properties	20% to 70% for non-rental property 30% to 105% for rental properties	20% to 70% for non-rental property 30% to 105% for rental properties	20% to 70% for non-rental property 30% to 105% for rental properties
<b>Credit Risk-Retail</b>	45% RW for transactors 75% for transactors/other retail	45% RW for transactors 85% for transactors/other retail	45% RW for transactors 75% for transactors/other retail Preferential 35% RW in defined circumstances	45% RW for transactors 75% for transactors/other retail Preferential 35% RW in defined circumstances	45% RW for transactors 75% for transactors/other retail	15% RW for transactors 75% for transactors/other retail
<b>Credit Risk-Banks</b>	20%/50% RW for exposures that are 3 months or less Securities firms can be treated as banks	No Short Term RW Securities firms must be treated as corporates	20%/50% RW for exposures that are 3 months or less Securities firms can be treated as banks	20%/50% RW for exposures that are 3 months or less Securities firms can be treated as banks	20%/50% RW for exposures that are 3 months or less Securities firms can be treated as banks	20%/50% RW for exposures that are 3 months or less Securities firms can be treated as banks
<b>Credit Risk-Small Medium Enterprises ("SMEs")</b>	85% RW for SMEs	No SME RW, 100% RW will be applied	85% RW for SMEs SME Support Factor	85% RW for SMEs	85% RW for SMEs	85% RW for SMEs
<b>Standardized Floor</b>	Model based approach floored at 72.5%	100% Standardized floor	Model based approach floored at 72.5%	Model based approach floored at 72.5%	Model based approach floored at 72.5%	Model based approach floored at 72.5%

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**Macro-Prudential Regulation and Other Market Reforms Post-GFC**


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- 2011: Resolution and recovery 165(d) plans<sup>89</sup>
  - 2012: Resolution and recovery insured depository institution plans<sup>90</sup>
  - 2012: Basel 2.5<sup>91</sup>
  - 2012: Mandatory swaps clearing (CFTC)<sup>92</sup>
  - 2013: Basel III<sup>93</sup>
  - 2013: Volcker Rule 1.0<sup>94</sup>
  - 2014: Enhanced Prudential Standards<sup>95</sup>
  - 2014: Liquidity Coverage Ratio<sup>96</sup>
  - 2014: Risk retention<sup>97</sup>
  - 2015: G-SIB surcharge<sup>98</sup>
  - 2015: Security-based swap dealer registration (registration date in 2021)<sup>99</sup>
  - 2015: Swap margin rule (CFTC, Prudential Regulators)<sup>100</sup>
  - 2017: Total Loss Absorbing Capacity<sup>101</sup>
  - 2017: Qualified Financial Contract stay / recordkeeping requirements<sup>102</sup>
  - 2018: Supplementary Leverage Ratio<sup>103</sup>
  - 2018: Single counterparty credit limits<sup>104</sup>
  - 2020: SA-CCR<sup>105</sup>
  - 2020: Stress Capital Buffer<sup>106</sup>
  - 2020: Volcker Rule 2.0<sup>107</sup>
  - 2020: Net Stable Funding Ratio<sup>108</sup>
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<sup>89</sup> 77 Fed. Reg. 67323 (November 1, 2011) (12 CFR Parts 243 and 381)

<sup>90</sup> 77 Fed. Reg. 3075 (January 23, 2012) (12 CFR Part 360).

<sup>91</sup> 77 Fed. Reg. 53060 (August 30, 2012) (12 CFR Parts 3, 208, 225, and 325).

<sup>92</sup> 77 Fed. Reg. 74284 (December 13, 2012) (17 CFR Parts 39 and 50).

<sup>93</sup> 78 Fed. Reg. 62018 (October 11, 2013) (12 CFR Parts 3, 5, 6, 165, 167, 208, 217, and 225).

<sup>94</sup> 79 Fed. Reg. 5536 (January 31, 2014) (12 CFR Parts 44, 248, and 351; 17 CFR Part 255).

<sup>95</sup> 79 Fed. Reg. 17240 (March 27, 2014) (12 CFR Part 252).

<sup>96</sup> 79 Fed. Reg. 61440 (October 10, 2014) (12 CFR Parts 50, 249, and 329).

<sup>97</sup> 79 Fed. Reg. 77602 (December 24, 2014) (12 CFR Parts 43, 244, 373, and 1234; 17 CFR Part 246; 24 CFR Part 267).

<sup>98</sup> 80 Fed. Reg. 49082 (August 14, 2015) (12 CFR Parts 208 and 217).

<sup>99</sup> 80 Fed. Reg. 48964, 48988 (August 14, 2015) (17 CFR Parts 240 and 249).

<sup>100</sup> 80 Fed. Reg. 74840 (November 30, 2015) (12 CFR Parts 45, 237, 349, 624, and 1221); 81 Fed. Reg. 636 (January 6, 2016) (17 CFR Parts 23 and 140).

<sup>101</sup> 82 Fed. Reg. 8266 (January 24, 2017) (12 CFR Part 252).

<sup>102</sup> 82 Fed. Reg. 42882 (September 12, 2017) (12 CFR Parts 217, 249, and 252); 82 Fed. Reg. 50228 (October 30, 2017) (12 CFR Parts 324, 329, and 382); 82 Fed. Reg. 56630 (November 29, 2017) (12 CFR Parts 3, 47, and 50).

<sup>103</sup> 83 Fed. Reg. 17318 (April 19, 2018) (12 CFR Parts 6, 208, 217, and 252).

<sup>104</sup> 83 Fed. Reg. 38460 (August 6, 2018) (12 CFR Part 252).

<sup>105</sup> 85 Fed. Reg. 4362 (January 24, 2020) (12 CFR Parts 3, 32, 217, 324, and 327).

<sup>106</sup> 85 Fed. Reg. 115576 (March 18, 2020) (12 CFR Parts 217, 225, and 252).

<sup>107</sup> 85 Fed. Reg. 46422 (July 31, 2020) (12 CFR Part 44).

<sup>108</sup> 86 Fed. Reg. 9120 (February 11, 2021) (12 CFR Parts 50, 249, and 329).