Office of the Comptroller of the Currency
400 7th Street, SW_ Suite 3E-218,
Washington, DC 20219
Attention: Chief Counsel's Office - Comment Processing
Docket ID OCC–2023–0008 and RIN 1557-AE78

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Attention: Ann E. Misback, Secretary
Docket No. R– 1813 and RIN 7100–AG64

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN 3064–AF29

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity

Submitted Via: *https://www.regulations.gov/.*

January 16, 2024

The CFA Institute Systemic Risk Council (SRC) appreciates the opportunity to comment on the above referenced rule making and its potential to improve systemic risk protections and economic stability. The SRC wholeheartedly supports the agencies' efforts to implement the Basel III international standards for large banks for three important reasons.

1. Long Overdue. These Basel 3 proposals are minimum standards that are long overdue, particularly in the areas of market and operational risk. They are an essential part of the commitments made to address gaps in systemic risk and improve the preparedness of our economic system following the worst financial disaster in the US economy since the Great Depression. In the many years since, a flow of proposals has continued to build economic resilience into our system . Basel 3 is an important capstone to this effort.
2. Existing Global Financial Crisis Reforms Fall Short. Industry advocates have suggested that the banking system is currently sufficiently capitalized and has easily weathered economic disruptions since the Global Financial Crisis (GFC). The fact is this fails to acknowledge the multiple forms of public support and assistance provided through systemwide mechanisms.

We have seen unprecedented levels of public support and assistance provided in the aftermath of the GFC, COVID pandemic and most recently, the use of the systemic risk exception was viewed by regulators as necessary in the case of the failures of Silicon Valley Bank and Signature Bank. We believe that the proposal is a meaningful step forward in ensuring that banking organizations maintain a level of regulatory capital that sufficiently reduces the probability that systemwide mechanisms will be invoked, particularly for large, operationally complex institutions with significant market exposures.

3. Global Progress, Simplicity and Consistency. The Basel III international standards were designed in the GFC aftermath to reduce the probability of global financial contagion and to reduce the likelihood that public support would be necessary during periods of severe economic downturn. These proposals are a key step for continued global coordination and simpler, standardized approaches to calculation of capital requirements for credit risk and operational risk, in particular. In all, these elements are conducive to a consistent application across banking organizations.

➢ *Executive Summary*

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) (together, the "agencies") have proposed the above referenced rulemaking ("proposed rule") for public comment. The proposed rule is summarized below.

The agencies are seeking comment on a proposed rule that would materially revise the regulatory capital requirements that apply to large banking organizations and to banking organizations with significant trading activity. A new framework for calculating risk-weighted assets, referred to as the expanded risk-based approach, would apply for large banks (defined as banking organizations with total assets of $100 billion or more and their subsidiary depository institutions). The expanded risk-weight approach introduces a new risk-based capital framework for calculation of capital requirement for credit, market, operational, and credit valuation adjustment risks.

The agencies say that the proposed rule would improve the calculation of risk-based capital requirements. It would better reflect the risks of these banking organizations' exposures, reduce the complexity of the regulatory capital framework, enhance the consistency of requirements across these banking organizations, and facilitate more effective supervisory and market assessments of capital adequacy.

Many of these benefits would be achieved by the proposed rule through replacing the use of internal models for credit risk and operational risk with standardized approaches and implementing revised methodologies for calculating risk-based capital for market risk and credit valuation adjustment risk. Importantly, the proposed rule would bolster a level playing field both domestically and internationally by applying risk-based capital regulations that are generally consistent with the Basel III international capital standards issued by the Basel Committee on Banking Supervision,

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➢ ***Summary of the Proposals***

The proposed rule aims to improve the strength and resilience of the banking system by modifying the regulatory capital framework applicable to large bank capital requirements to:

- Better reflect underlying risks; and
- Increase the transparency and consistency of the regulatory capital framework.

These goals would be accomplished by revising the capital framework for large banking organizations in four main areas:

- Credit risk, which arises from the risk that an obligor fails to perform on an obligation,
- Market risk, which results from changes in the value of trading positions[1],
- Operational risk, which is the risk of losses resulting from inadequate or failed internal processes, people, and systems, or from external events, and
- Credit valuation adjustment risk, which results from the risk of losses on certain derivative contracts.

Specific features of the proposed rule include:

- Eliminating the ability of banking organizations to use internal model-based approaches for the calculation of capital requirements for credit risk and operational risk.
- Introducing a new "Expanded Risk-Based Approach," that establishes a revised set of standardized risk-based requirements for the calculation of credit risk, operational risk, CVA risk, and market risk.
- Strengthening the market risk requirements by replacing the use of Value-at-Risk (VaR) models with Expected Short-fall based measures that are aimed at increasing risk sensitivity associated with trading activities.
- Requiring large banking organizations to apply a "dual-requirement framework" whereby such organizations will calculate their risk-weighted asset amounts under the current standardized approach and the expanded risk-based approach and use the higher of the two risk-weighted asset amounts to meet their minimum capital requirements. The dual-requirement framework is designed to ensure that the capital requirements applicable to large banking organizations are never lower than the capital requirements applicable to smaller banking organizations.
- In response to banking disruptions experienced in March 2023, the proposed rule seeks to further strengthen the banking system by requiring all banking organizations with total assets of $100 billion or more to calculate the numerator of their regulatory capital ratios using the same approach. Under this approach, all large banking organizations would be subject to the same treatment of accumulated other comprehensive income (AOCI), capital deductions, and rules for minority interest. In addition, all large banks would be

[1] **The modifications to regulatory capital framework related to market risk would also apply to banks with total assets of less than $100 billion that have significant trading exposure. A banking organization is defined as having significant trading exposure if the banking organization has** $5 billion or more in trading assets plus trading liabilities or for which trading assets plus trading liabilities exceed 10 percent of total assets.

required to comply with the supplementary leverage ratio requirement, and the countercyclical capital buffer, if activated.

➢ ***General Comments***

The "Holding" of Capital. Speeches and articles about the agencies' regulatory capital rules often describe them as defining the amount of capital that banking organizations are required to "hold" as a cushion against losses. Some of these speeches and articles go further to state that the more capital a banking organization must "hold," the less the banking organization can lend. This type of discourse – even well-intentioned – leaves the impression that capital is either akin to an asset that is held in lieu of making loans or that capital is funds held in escrow releasable only when, and to the extent, a bank suffers a loss on a loan or other asset. Capital is the primary source of funding for banking organizations. Capital includes the amount that shareholders have invested in a banking organization and represents the amount of funding that the banking organization does not have to repay. Capital is primarily comprised of shareholder paid-in equity and the amount of historical earnings that the banking organization has retained. In general, when banking organizations increase the amount of capital that they "hold," they do so by increasing retained earnings—in other words, they pay lower dividends to shareholders and buy back fewer shares from the stock market. When banking organizations need to "raise" additional capital required by the agencies' proposed rule, they expect to do so by paying less dividends to shareholders and buying back fewer shares over the next several quarters. As a result, the proposed regulations would require shareholder to take a greater economic stake in the banking organization, creating an incentive for shareholders to more thoroughly understand and more closely monitor the risks undertaken by the organization.

To add a finer point to this discussion, capital is calculated as the difference between a banking organization's assets and its liabilities. Capital does not represent a financial asset on its own; rather it is the claim that shareholders have on the banking organization upon liquidation. In other words, capital is represented by the excess of the value of a banking organization's assets, (cash, securities, loans, real estate, etc.) over its liabilities (deposits, trading liabilities, subordinated notes, etc.). As such, capital represents the economic stake that shareholders have in a banking organization's activity, including lending.

The Relationship between Capital and Lending. Some industry advocates have long argued that higher regulatory capital requirements will result in the higher cost of credit and ultimately, reduced availability of credit for economic growth. The premise behind this relationship is that equity capital is more expensive for banking organizations than other forms of funding, such as deposits and unsecured debt, and consequently, higher requirements for equity capital will result in an increased cost of funding that will be passed on to borrowers, consumers, and other bank counterparties.

In their proposal, the agencies stated that they anticipate a modest reduction in bank lending activities, which could have implications for economic growth. However, the agencies note that they expect reductions in lending for those activities that result in exposures with higher risk-weights under the proposed rule. [2] The agencies anticipate that the proposal would slightly decrease marginal risk-weights for retail and commercial real estate exposures and slightly increase marginal risk-weights for corporate, residential real estate and securitization exposures.[3] Thus, on balance and contrary to statements made by industry advocates, the agencies' proposed rule, while more risk-sensitive than current standards, would not materially affect credit availability to main street consumers.

It is also the case that the bulk of any significant increase in risk-weighted assets under the proposed rule is attributable to trading activity, which the agencies expect to have more than twice the risk-weighted impact as changes to the lending activity. Accordingly, the greatest impact of the proposed rule arises from changes to the risk-based capital framework related to banking organizations' capital markets and trading activities, which the Council feels is the correct focus and at most, have only an indirect impact on Main Street consumers.

It is important to remember that regulatory capital requirements are only one of a plethora of factors that weigh into the availability and cost of credit. Other factors include current and expected economic conditions; bank organizations' risk appetites, strategic plans, business models; and competition-driven factors, among others. For some banking organizations, higher capital levels can support higher risk appetites, which in turn can support higher levels of retail lending. For other banking organizations, higher capital levels can create friction for business models geared toward trading activities that compete against organizations with little-to-no capital requirements and these organizations may choose to reduce retail lending to support their business model. As such, it is not surprising that many academic studies have suggested that there is a tenuous linkage between higher capital requirements and reduced lending activity.[4]

<u>The Relationship between Capital and Financial Stability</u>. Because losses are absorbed by equity capital, research has shown that higher capital requirements can provide banking organizations with a greater level of loss absorbency thereby reducing the probability of default of individual banking organizations, reducing overall systemic risk, and likely reducing the probability of banking crisis. In addition, highly capitalized banking organizations are often better equipped to weather

[2] See 88 F.R. 64167–64171 (September 18, 2023).

[3] While risk weight for residential mortgages will increase under the proposed rule, the overall impact on consumers is expected to be modest, if not immaterial, as approximately 70 percent of all first-lien single family mortgages are held in agency mortgage-backed securities issued by GSE or private-label mortgage-backed securities. See Urban Institute, "Housing Finance at a Glance: A Monthly Chartbook," December 2023, https://www.urban.org/sites/default/files/2024-01/HOUSING_FINANCE_AT_A_GLANCE_CHARTBOOK_DEC23.pdf.

[4] See Carlson, Mark, Hui Shan, and Missaka Warusawitharana, 2013, "Capital Ratios and Bank Lending: A Matched Bank Approach," Journal of Financial Intermediation, 22(4):663–687; Chu, Yongqiang, Donghang Zhang, and Yijia Zhao, 2019, "Bank Capital and Lending: Evidence from Syndicated Loans," Journal of Financial and Quantitative Analysis, 54(3): 667–694; Gambacarta, Leonardo, and Hyun Song Shin, 2018, "Why Bank Capital Matters for Monetary Policy," Journal of Financial Intermediation, 35(B): 17–29; Kim, Dohan, and Wook Sohn, (2017), "The Effect of Bank Capital on Lending: Does Liquidity Matter?" Journal of Banking and Finance, 77: 95–107; and Dursun-de Neef, H. Özlem, and Alexander Schandlbauer, 2020, "Procyclical Leverage: Evidence from Banks' Lending and Financing Decisions," Journal of Banking & Finance, 113:105756.

economic downturns and more likely to be able to continue to lend during difficult market and economic conditions.[5]

Global Financial Crisis Reforms Are Not Adequate- Why More? Industry advocates have suggested that the banking system is currently sufficiently capitalized, and that additional capital is not necessary to secure financial stability. To support this assertion, industry advocates point to the ability of banking organizations to weather the dire economic downturns associated with the COVID pandemic, pointing to the low number of bank failures during this period and the ability of banking organizations to remain well-capitalized. To a lesser extent, industry advocates also point to the ability of banking organizations to weather the financial turbulence in early 2023, again with a limited number of failures.

This line of argumentation is somewhat counterfactual as it does not consider properly the multiple forms of public support and assistance provided through systemwide mechanisms either directly to banking organizations (such as through Federal Reserve lending facilities or U.S. Treasury capital facilities) or indirectly through public assistance programs (such as economic impact payments and the paycheck protection program). Unprecedented levels of public support and assistance were provided in the aftermath of the Global Financial Crisis (GFC) and the COVID pandemic. Most recently, the use of the systemic risk exception was viewed by regulators as necessary in the case of the failures of Silicon Valley Bank and Signature Bank[6] with the Federal Reserve providing systemwide support through the Bank Term Funding Program.[7]

The fact is, the continued use of systemwide mechanisms in the event of failure, or potential failure, of an individual bank likely camouflages the systemic risk gaps that still remain in our financial system, despite GFC reforms. These mechanisms may become prone to overuse. We believe that the proposal is a meaningful step forward in ensuring that banking organizations

[5] See Basel Committee on Banking Supervision, 2010, "An assessment of the long-term economic impact of stronger capital and liquidity requirements;" Slovik, Patrick and Boris Courne`de, 2011, "Macroeconomic Impact of Basel III", OECD Economics Department Working Papers 844; Booke, Martin et al., 2015, "Measuring the macroeconomic costs and benefits of higher UK bank capital requirements," Bank of England Financial Stability Paper 35; Dagher, Jihad, Giovanni Dell'Ariccia, Luc Laeven, Lev Ratnovski, and Hui Tong, 2016, "Benefits and Costs of Bank Capital," IMF Staff Discussion Note 16/04; Firestone, Simon, Amy Lorenc, and Ben Ranish, 2019, "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US," St. Louis Review Vol. 101 (3); Begenau, Juliane and Tim Landvoigt, 2022, "Financial Regulation in a Quantitative Model of the Modern Banking System," The Review of Economic Studies 89(4): 1748–1784; Irani, Rustom M., Rajkamal Iyer, Ralf R. Meisenzahl, and Jose-Luis Peydro, 2021, "The Rise of Shadow Banking: Evidence from Capital Regulation." The Review of Financial Studies 34: 2181–2235; Miles, David, Jing Yang, and Gilberto Marcheggiano, 2013, "Optimal Bank Capital," The Economic Journal 123: 1–37; Van den Heuvel, Skander, 2022, "The Welfare Effects of Bank Liquidity and Capital Requirements," FEDS Working Paper; Elenev, Vadim, Tim Landvoight, Stijn van Nieuwerburgh, 2021, "A Macroeconomic Model with Financially Constrained Producers and Intermediaries," Econometrica 89(3): 1361–1418; Macroeconomic Assessment Group, 2010, "Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements," Final Report.

[6] See Joint Statement by the Department of the Treasury, the Federal Reserve, and the FDIC, March 12, 2023. Available at https://www.fdic.gov/news/press-releases/2023/pr23017.html

[7] See https://www.federalreserve.gov/financial-stability/bank-term-funding-program.htm

maintain a level of regulatory capital that sufficiently reduces the probability that systemwide mechanisms will be invoked.

The Importance of Global Progress. The Basel III international standards were designed in the GFC aftermath to reduce the probability of global financial contagion and to reduce the likelihood that public support would be necessary during periods of severe economic downturn. The Basel Committee on Banking Supervision issued the initial Basel III standards in December 2017, followed by the final market risk capital standards in January 2019 and the extension of the implementation date for these reforms by one year, to January 01, 2023, in the backdrop of the COVID-19 pandemic.

To date, regulatory jurisdictions like the European Union and the United Kingdom are still in the process of finalizing these rules and expect to implement these rules beginning from January 01, 2025, followed by a five-year phase-in period for output floor requirements. Switzerland is also expected to finalize the Basel III rules this year. Canada and many Asian jurisdictions, such as Japan and Singapore, have already finalized their regulations. The United States is one key jurisdiction that has just now started the consultation process for these final Basel III rules.

To strengthen the international financial system and to ensure a level international playing field, it is imperative for the United States to move forward expeditiously on the implementation of Basel III, subject to appropriate consideration of public comments.

The International Basel III Standards are Minimum Standards. Industry advocates have pointed out that in certain portions of the agencies' proposed rule banking organizations would be subject to more robust requirements or would be required to assign higher risk weights than required by the international standards. It is important to note that the Basel III standards are international minimum standards and that jurisdictions can – and should – require enhanced standards as necessary to preserve the safety and soundness and financial stability of local markets.

We encourage the banking agencies to consider additional standards where appropriate, while taking into account concerns about international competitiveness. In any event, American banks should adhere to the minimum standards contained in Basel III standards.

Application of Basel III to Non-Internationally Active Banks. We support the agencies' application of the Basel III standards to large banking organizations defined as banking organizations with total assets of $100 billion or more and their subsidiary depository institutions. The recent failures of Silicon Valley Bank and Signature Bank and the subsequent invocation of systemic risk exception demonstrates that the failure of one or more banking organizations with assets of $100 billion or more could, in the regulators' view, risk destabilizing effects that pose significant risk to the U.S. financial system.

Furthermore, we believe that the agencies' proposed rule addresses several of the shortcomings identified by the failure of Silicon Valley Bank and Signature Bank. For example, these banking organizations were not required to include in their capital calculation unrealized losses on their available-for-sale securities as required by Basel III standards, nor were they required to maintain the level of high-quality liquid assets required under the Basel III standards. The agencies' proposal would require all large banking organizations to apply the Basel III numerator which includes accumulated other comprehensive income (AOCI), capital deductions, and rules for minority interest in their common equity tier 1 calculations. In addition, the proposed rule would require large banks to maintain a more robust liquidity coverage ratio that, consistent with Basel III, requires large banks to hold sufficient high-quality liquid assets to cover 30 days of stressed liquidity outflows. While there is conflicting analysis as to whether such requirements would have prevented SVB's and Signature Bank's failure, there is no doubt they would have been in a stronger capital position which would have reduced the attendant losses to the FDIC's deposit insurance fund.

- ***Additional SRC Comments***

The Importance of Simplicity and Consistency. We support the agencies' decision to eliminate the use of internal model-based approaches for the calculation of capital requirements for credit risk and operational risk in favor of simpler standardized approaches that are conducive to a consistent application across banking organizations. This decision is consistent with the Basel III standard that allows jurisdictions the discretion to eliminate such models.

We encourage the banking agencies and the Basel Committee on Banking Supervision to continue to work toward the development of simpler, more principle-based approaches that can be consistently applied across banks and jurisdictions. We understand that simpler approaches can come at the cost of risk sensitivity and encourage regulators to use parsimonious modeling methodologies when standardized approaches cannot achieve appropriate risk sensitivity.

At the same time, we encourage the agencies to consider the administrative costs of implementing highly complex rules, particularly for smaller regional banks. We strongly support a capital framework that prevents larger banks from having weaker capital requirements than smaller institutions. However, that can be achieved by letting regionals below $250 billion continue to use the current standardized credit risk weights. This would avoid the administrative costs and burdens of requiring that they also calculate capital minimums under the new, more complex, expanded standardized risk weights. The proposed expanded standardized approach would actually require less capital than current requirements. The credit quality of a loan is determined by the characteristics of the borrower, not the size of the lender. We also encourage regulators to assess whether it is necessary to change mortgage risk weights for banks of any size given that the current 50% risk weight, combined with stronger consumer protections and more stringent underwriting requirements, have resulted in highly stable mortgage markets.

Enhanced Economic Impact Analysis. We appreciate the additional work now being completed by the Federal Reserve to provide a more comprehensive and detailed economic impact analysis as part of the Basel III endgame capital proposal. We look forward to this additional information.

➢ *Conclusion*

We appreciate the opportunity to provide these comments and strongly support the agencies' implementation of Basel III standards to large banking organizations as defined in the agencies' proposed rule. We believe that the proposed rule is an important step in ensuring that large banking organizations are appropriately capitalized to withstand severe economic downturns without the need to resort to the use of taxpayer dollars or extraordinary support measures.

We encourage the agencies to carefully consider and respond to public comments received on the proposed rule, and to move forward as expeditiously as possible on the implementation of final standards that, as a whole, are no less stringent than the Basel III international standard.

Thank you for the opportunity to comment. We provide these views on behalf of the CFA Institute Systemic Risk Council.

Respectfully submitted,

Simon Johnson, Co-Chair

Erkki Liikanen, Co-Chair

Note: The views expressed herein represent the collective views of the SRC and not all members agree with all aspects of this comment letter.

Members of the CFA Institute Systemic Risk Council

Chair: Simon Johnson

SRC Co-Chair and former IMF Chief Economist

Chair: Erkki Liikanen

SRC Co-Chair and Chairman of the IFRS Foundation Board of Trustees

Senior Advisor: Sheila C. Bair

Founding Chair of Systemic Risk Council and Former FDIC Chair

Senior Advisor: Jean-Claude Trichet

Former President of the European Central Bank

Paul P. Andrews

Managing Director, Research, Advocacy, and Standards, CFA Institute. Former Secretary General of the International Organization of Securities Commissions (IOSCO)

Brooksley Born

Former U.S. Commodity Futures Trading Commission Chair

Sharon Bowles

Former Member of European Parliament and Former Chair of the Parliament's Economic and Monetary Affairs Committee

Bill Bradley

Former U.S. Senator (D-NJ)

Marina Brogi

Full Professor of Banking and Capital Markets at Sapienza University of Rome and a former member of the Securities and Markets Stakeholder Group at the European Securities and Markets Authority (ESMA).

Andreas Raymond Dombret

Former member of executive board Deutsche Bundesbank, founding member of the Supervisory Board of the European Central Bank;' board member Bank of International Settlements

William Donaldson

Former U.S. SEC Chair

José Manuel González Páramo

Spanish economist who served as a member of the Executive Board of the European Central Bank (ECB), Executive Board member of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), and Executive Board member of Bank of Spain

Jeremy Grantham

Co-founder & Chief Investment Strategist, Grantham Mayo Van Otterloo (GMO)

Richard Herring

The Wharton School, University of Pennsylvania

René Karsenti

Senior Advisor to the International Capital Market Association (ICMA)

Elke König

Former Chair of the Single Resolution Board (SRB)

Ira Millstein

Senior Partner, Weil Gotshal & Manges LLP

John S. Reed

Former Chairman and CEO of Citicorp and Citibank

Christina Romer

Professor at the Graduate School at the University of California, Berkeley

For more information about this comment letter or the CFA Institute Systemic Risk Council please contact: Kurt Schacht J.D., CFA |Executive Director- CFA Institute Systemic Risk Council | 1401 New York Ave. NW, Suite 330, Washington D.C. 20005 |kurt.schacht@cfainstitute.org |