Date: July 18, 2023
To: Board of Governors
From: Staff
Subject: Proposals that would amend capital requirements for large banking organizations in line with the Basel III accord and modify risk-based capital surcharges applicable to U.S. GSIBs.

**ACTIONS REQUESTED:** Approval to publish two proposals for public comment in the Federal Register: (1) a proposal that would revise the Board’s risk-based capital framework applicable to firms with at least $100 billion in total assets and their depository institution subsidiaries and to firms with significant trading activities to improve risk sensitivity;\(^2\) and (2) a proposal that would improve the sensitivity of the risk-based capital surcharge for global systemically important banking organizations (GSIBs) to changes in a firm’s systemic risk profile.\(^3\) Staff also requests authority to make technical, non-substantive changes to the attached materials prior to publication in the Federal Register. The risk-based capital proposal would be

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\(^2\) In addition to revising risk-based capital requirements, this proposal would also revise the applicability of the supplementary leverage ratio and countercyclical capital buffer requirements to include all firms with at least $100 billion in total assets and their depository institution subsidiaries.

\(^3\) Each proposal would include amendments to regulatory reports to maintain alignment with the proposed changes to the related regulations. As appropriate, the Federal Financial Institutions Examination Council is also expected to propose amendments to its reporting forms in the near term.
issued jointly by the Board, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency. The GSIB surcharge proposal would be issued by the Board alone.

EXECUTIVE SUMMARY:

- The two proposals for public comment would improve the comprehensiveness, consistency, and transparency of the capital requirements applicable to large banking firms.
- The first proposal would replace the agencies’ risk-based capital framework for large firms with a new framework consistent with standards issued by the Basel Committee on Banking Supervision. The proposal would:
  - Apply to firms with at least $100 billion in total assets and to their depository institution subsidiaries; its market risk provisions would also apply to smaller firms with significant trading activities;
  - Reduce the ability of firms to use internal models for measuring capital requirements, as such models can result in unwarranted variation in requirements across firms;
  - Require firms to use more risk-sensitive standardized approaches to ensure appropriate capitalization for credit, market, and operational risk exposures, while limiting variation in capital requirements across firms; and
  - Not change capital requirements for smaller, less complex firms.
- The second proposal would revise the calculation of the GSIB risk-based capital surcharge to ensure that the surcharge is more reflective of a GSIB’s systemic risk profile.
- The changes to capital requirements under the two proposals would increase the resilience of large firms and enhance financial stability.
  - More appropriate capitalization of certain risks would increase overall capital requirements. The impact on capital requirements derives mostly from the first proposal, which would increase common equity tier 1 capital requirements for large firms by an estimated 16 percent. Additional elements of the proposal could lead to a further moderate increase in requirements for some firms over the long run, depending on prevailing economic conditions.
- Comments on the proposals would be accepted through November 30, 2023.
DISCUSSION:

A. Background

Following the 2007-09 financial crisis, the Board adopted reforms to improve the effectiveness of the regulatory capital framework, including a final rule in 2013 that increased the quantity and quality of required regulatory capital. These changes were broadly consistent with the initial set of Basel III reforms published by the Basel Committee on Banking Supervision. The Board also implemented capital planning and stress testing requirements for large firms; additional capital buffer requirements to mitigate the financial stability risks posed by U.S. GSIBs in the leverage framework (the enhanced supplementary leverage ratio) and in the risk-based framework (the GSIB surcharge); and other enhanced prudential standards, consistent with the Dodd-Frank Act.

Currently, firms subject to Category I or II prudential standards calculate two risk-based capital measures. One is the U.S. standardized measure, which generally is applicable to all U.S. banking firms, and the other is an “advanced approaches” measure that applies only to firms subject to Category I or II prudential standards and relies on these firms’ internal models and data to assess the risk of their activities. The proposals would build on the post-crisis reforms by implementing the risk-based capital standards contained in the final set of Basel III reforms, known as the Basel III endgame reforms, as well as additional provisions informed by more recent experience.

B. Improving the comprehensiveness, consistency, and transparency of capital requirements for large firms

The risk-based capital proposal would improve the comprehensiveness, consistency, and transparency of capital requirements applicable to large firms and reduce complexity and operational costs through changes across multiple areas of the risk-based capital framework. As
described below, the risk-based capital proposal would (1) introduce a new approach to calculate risk-weighted assets, consistent with the Basel III endgame reforms (the “expanded risk-based approach”); and (2) consistently apply the new risk-based capital framework to all large firms. In doing so, the risk-based capital proposal would replace the “advanced approaches” measure with a new risk-based capital measure as described below.

Revisions to the calculation of risk-weighted assets

The risk-based capital proposal would introduce the expanded risk-based approach, which includes risk-weighted assets for credit, equity, operational, market, and credit valuation adjustment risk. The proposed risk-weighting methodologies would be standardized (except for market risk, for which use of internal models would still be allowed subject to enhanced supervisory standards) to improve consistency of requirements across banks and over time. The expanded risk-based approach would be more risk-sensitive than the current standardized approach by incorporating more credit-risk drivers (for example, borrower and loan characteristics) and explicitly differentiating between more types of risk (for example, operational risk). In this manner, the expanded risk-based approach would better account for key risks faced by large firms.

The expanded risk-based approach would replace the Board’s internal models-based capital requirements for credit and operational risk in the current advanced approaches. Internal models used in this context rely on a firm’s choice of modeling assumptions and include a degree of subjectivity, which in supervisors’ experience can result in unwarranted variability in requirements for exposures with similar risks. The variability and complexity of these models-based approaches can reduce the transparency of the capital ratios, challenge comparisons of
capital adequacy across firms, and reduce confidence in the adequate capitalization of risk positions.

By contrast, the expanded risk-based approach would improve the consistency of capital requirements by limiting management discretion. The standardized requirements, together with robust public disclosure and reporting requirements, would enhance the ability of supervisors and market participants to make independent assessments of a firm’s capital adequacy, individually and relative to its peers. Replacing internal models-based approaches with standardized approaches would also significantly simplify the capital framework and reduce costs associated with maintaining such modeling systems.

The risk-based capital proposal would also substantially improve the risk-sensitivity and calibration of market risk capital requirements, including by better accounting for stress losses and increasing the requirements applied to less liquid trading positions. Furthermore, the proposal would introduce a standardized methodology for calculating risk-weighted assets for market risk and would require a firm to obtain prior approval from its primary federal supervisor to use any internal models-based approach. In contrast to credit and operational risk, the proposal would continue to permit firms to use internal models for market risk, while limiting their use to trading activities for which such models continue to appropriately capture market risk.

The proposal would maintain the current capital rule’s dual-requirement structure, such that a large firm would be required to calculate its risk-based capital ratios under both the proposal’s expanded risk-based approach and the existing standardized approach. Large firms would be subject to the stricter of the resulting ratios for their risk-based capital minimum ratio and buffer requirements, including the stress capital buffer requirement.
Application of the new risk-based capital framework to all large firms

The expanded risk-based approach would apply to firms with total assets of $100 billion or more and their subsidiary depository institutions.\(^4\) This approach would provide more risk-sensitive and consistent requirements, which better account for the risks of these firms. The Board had previously determined that the burden of the internal models-based advanced approaches requirements exceeded the benefits for firms subject to Category III or IV capital standards. The expanded risk-based approach would be much less complex and burdensome to implement than the advanced approaches and, as a result, the proposal would apply the expanded risk-based approach to all large firms.

The proposal would also align the calculation of regulatory capital for firms subject to Category III or IV capital standards with the calculation for firms subject to Category I or II capital standards, providing a single approach for large firms. Among other items, firms subject to Category III or IV standards would be required to reflect accumulated other comprehensive income in regulatory capital, which would better reflect their capacity to absorb losses.

To further align capital requirements across large firms and enhance the resilience of firms subject to Category IV standards, the proposal would extend the countercyclical capital buffer and the supplementary leverage ratio requirements to firms subject to Category IV standards.

\(^4\) In addition, the revised requirements for market risk would apply to any firm with $5 billion or more in trading assets plus trading liabilities or for which trading assets plus trading liabilities equal 10 percent or more of the firm’s total assets.
Transition

Both the introduction of the expanded risk-based approach for all large firms and the inclusion of AOCI in the regulatory capital of firms subject to Category III or IV standards would be subject to an appropriate phase-in so that firms can plan appropriately.

C. Improving the risk-sensitivity of the GSIB surcharge

The second proposal would improve the sensitivity of the risk-based capital surcharge for GSIBs to changes in a firm’s systemic footprint. Under the capital rule, a GSIB must maintain an additional capital buffer (known as its GSIB surcharge) to strengthen the firm’s resiliency based on the risks its failure or distress could pose to the U.S. financial system.

The proposal would improve the calculation of GSIB surcharges to better match a firm’s systemic footprint. First, the proposal would measure on an average basis over the full year the systemic indicators that are currently measured only as of year-end. This change would better reflect the risk profile of a firm and reduce incentives for a firm to reduce its GSIB surcharge by temporarily altering its balance sheet at year end. Second, the proposal would reduce cliff effects in the GSIB surcharge by measuring GSIB surcharges in 10-basis point increments instead of 50-basis point increments. Third, the proposal would make improvements to the measurement of some systemic indicators to better align them with risk.

D. Improving the resilience of large firms

Collectively, the proposals would enhance the alignment of capital requirements to the risks of firms’ exposures and increase incentives for prudent risk management. The more risk-sensitive and consistent capitalization of risks in the proposals would increase overall requirements for most large firms. Staff estimates that the changes to risk-weighted assets and the definition of regulatory capital would account for almost all of the increase. The changes to
risk-weighted assets would increase aggregate binding common equity tier 1 capital requirements by about $170 billion, or 16 percent, for the holding companies covered by the proposal. On a relative basis, the capital requirements would increase somewhat more (19 percent) for Category I and II firms, and somewhat less for Category III and IV domestic firms (6 percent) and intermediate holding companies of foreign firms (14 percent). The estimated effect of the changes to the definition of regulatory capital is to increase capital requirements by a moderate amount over the long run for Category III and IV firms, with somewhat larger increases for foreign firms and smaller increases for domestic ones.

The increases in risk-sensitivity and overall capital levels would improve the safety and soundness of individual firms and contribute to overall financial stability, although there are some costs associated with higher levels of capital.

Capital requirements would modestly increase for lending activities, which could result in a slight reduction in bank lending. However, staff estimates the economic costs of this modest reduction resulting from the proposal’s strengthened requirements would be offset by the economic benefits of a more resilient financial system.

Capital requirements for trading activities are estimated to increase substantially, more than doubling for some firms, though the ultimate impact would vary substantially depending on firms’ individual business activities and use of internal models. Increased market risk capital requirements could reduce the financial market participation of large firms. Still, the improved risk-sensitivity, particularly for less liquid positions, would enhance the resilience of bank-affiliated broker-dealers and could benefit the provision of liquidity, especially during periods of stress.
The changes to the definition of regulatory capital, by reflecting accumulated other comprehensive income, would better reflect the capacity of Category III and IV firms to absorb losses. This could create better incentives for firms to manage the risks of their securities portfolios, although the changes could also create incentives for firms to increase the share of securities classified as held-to-maturity.

The GSIB surcharge proposal would improve the measurement of firms’ systemic footprints and reduce incentives for GSIBs to make temporary changes to usual business activities to achieve a lower capital surcharge. Staff estimates that the proposal would have a small impact on GSIB capital surcharges, with changes ranging from –10 to +40 basis points. ⁵

To refine the estimates of the effect of the proposals on capital requirements, staff expects to undertake a data collection following issuance of the proposal. Information gathered through this data collection would inform finalization of the rule.

RECOMMENDATIONS:

For the reasons discussed above, staff recommends that the Board approve the attached draft notices of proposed rulemaking. Staff also recommends that the Board authorize staff to make technical, non-substantive changes to the attached materials prior to publication.

⁵ In addition to its impact on U.S. GSIBs, the GSIB proposal could increase the category of prudential standards applicable to some foreign banking organizations currently subject to Category III or IV standards. Specifically, the proposal would revise the cross-jurisdictional activity systemic indicator to include derivatives. This change could increase reported values of this indicator for some firms, which could result in some foreign banking organizations becoming subject to Category II standards. The categories of prudential standards for domestic firms would likely not be affected by the proposal, based on estimated values for this indicator.