

**Meeting Between Governor Waller and Staff of the Federal Reserve Board and Representatives of the Bank Policy Institute (BPI) and Several Banking Organizations**  
**February 13, 2024**

**Participants:** Governor Christopher J. Waller, Asad Kudiya, and Robert Sarama (Federal Reserve Board)

Greg Baer, Kathryn Collard, John Court, Francisco Covas, Janel Dupuis, Tabitha Edgens, Emily Harris, Greg Hopper, Shamika Patton, William Nelson, and Brett Waxman (BPI)

Jeremy Barnum (JPMorgan); Denis Coleman (Goldman Sachs); Peter Crawford (Charles Schwab); Hope Dmuchowski (First Horizon); Russell Hutchinson (Ally); Clark Ibrahim (KeyCorp); Michael Maguire (Truist); Eddy Okhuijsen (HSBC); Bryan Preston (Fifth Third); Michael Santomassimo (Wells Fargo); David Turner (Regions); Sharon Yeshaya (Morgan Stanley)

**Summary:** Governor Waller and staff of the Federal Reserve Board met with representatives and counsel of BPI and several banking organizations to discuss a range of issues including the agencies' Basel III endgame notice of proposed rulemaking, the agencies' notice of proposed rulemaking on long-term debt requirements, the Board's notice of proposed rulemaking on Regulation II, as well as other topics including stress testing and liquidity. The representatives verbally expressed views in the meeting consistent with those expressed in their written presentation.

Attachment



# **BPI CFO Forum**

**February 13, 2024**

# Agenda

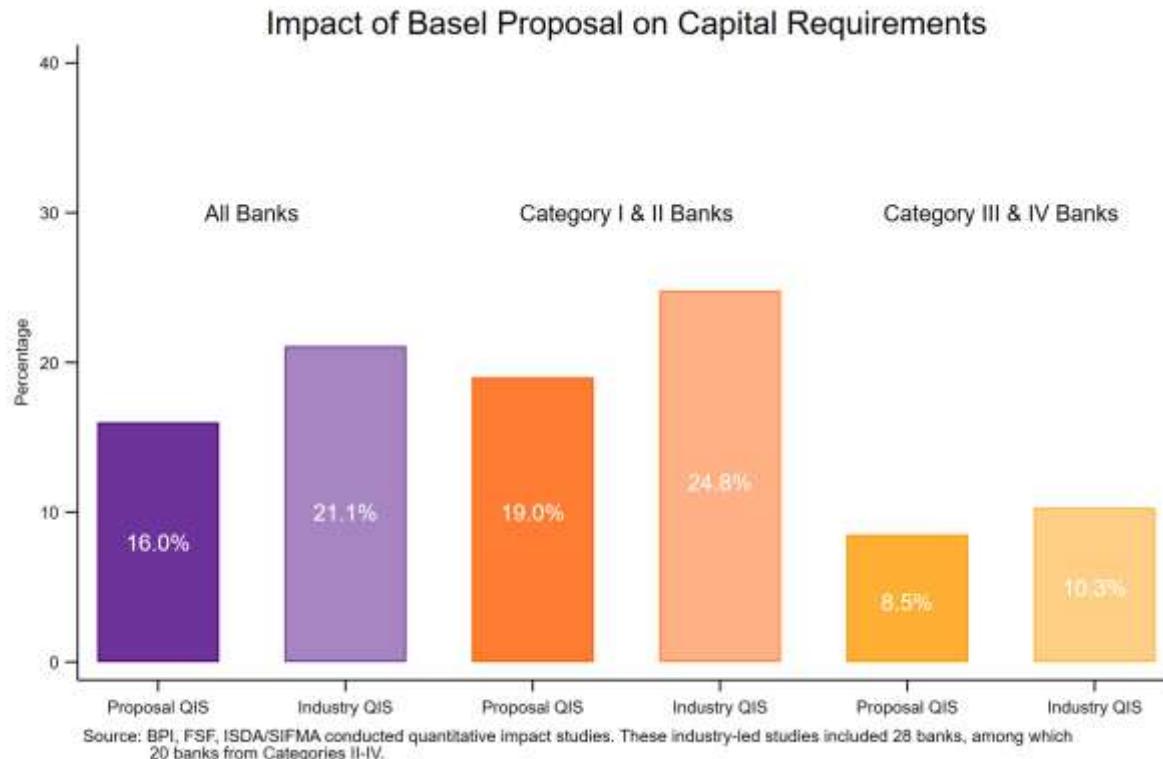
1. Selected Topics on the Basel Proposal
  - a) Why a reproposal is the path forward
  - b) Overcalibration of operational risk
  - c) Interplay between the market risk and CVA elements of the proposal and the Global Market Shock in the stress tests
  - d) Lack of tailoring
2. Long-Term Debt Proposal
3. Stress Testing
4. Reg II Proposal
5. Liquidity

# Why a reproposal is the path forward

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# Initial Agency estimates were significantly understated

- The industry QIS shows a material increase in risk-weighted assets and capital requirements relative to the agencies' own estimate included in the July proposal.
  - It would increase Category I-IV banks capital requirements by 21 percent – about 5 percentage points higher than the agencies' initial estimate.
  - The primary cause of the agencies' underestimation is credit risk.
  - The agencies' underestimation of the proposal's impacts means that a significant downward adjustment is necessary to appropriately balance the costs and benefits of any changes to the capital rules.



# **Resolving issues with proposal's empirical support require fundamental reassessment and reproposal.**

- The breadth of feedback from sectors outside the banking industry underscores the need to conduct a robust cost-benefit analysis of the proposal.
- It is also imperative that the agencies reconsider the proposal in the context of other elements of the capital framework, including the interplay with the stress tests.
- The agencies should also analyze the impact of revised bank capital standards on the U.S. economy and capital markets.
- Any revised or expanded analyses or adjustments to the proposal must be made part of the record and available for public comment.

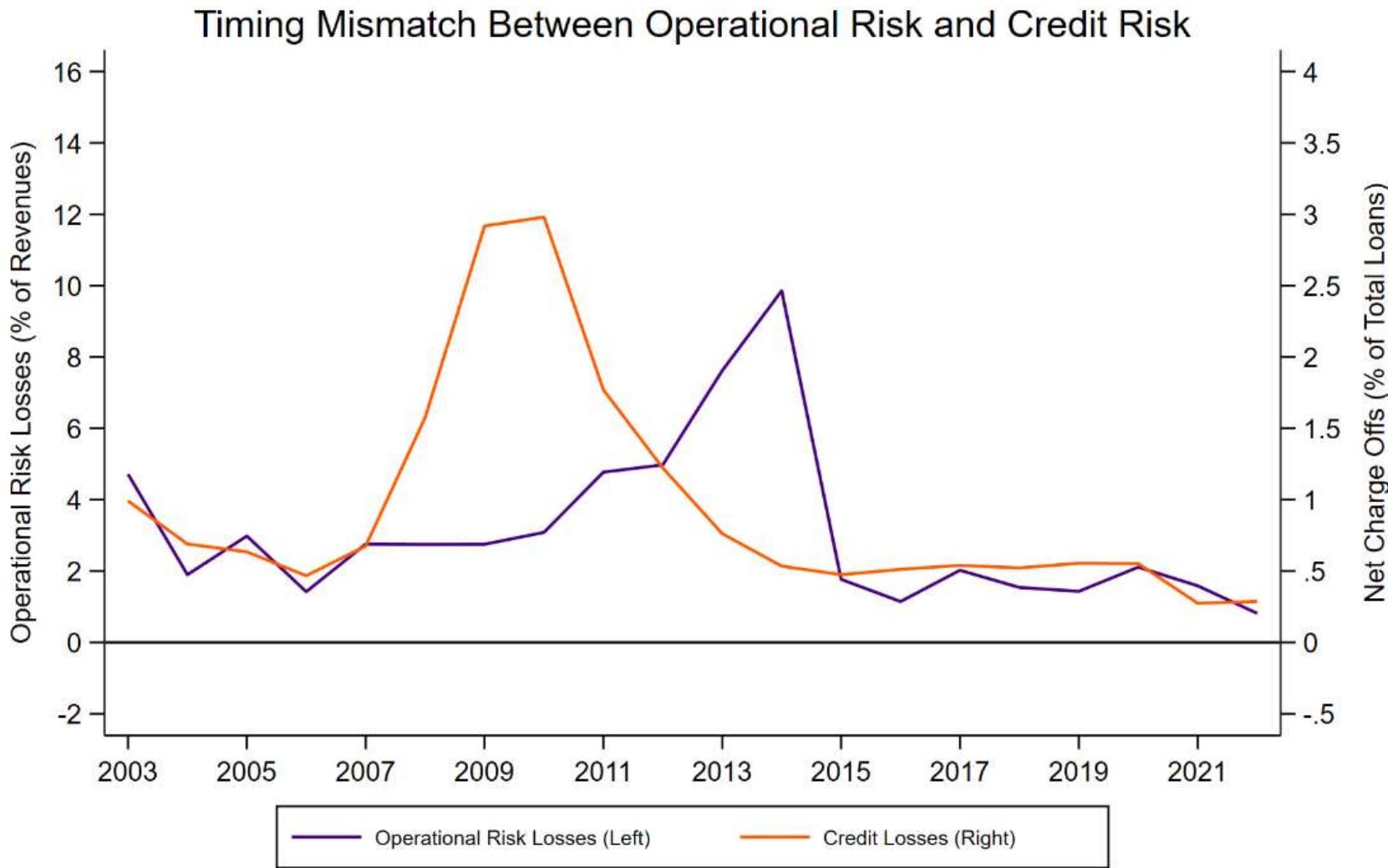
# Overcalibration of operational risk capital requirements due to Basel Proposal

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# Governor Waller has highlighted important considerations for operational risk standards

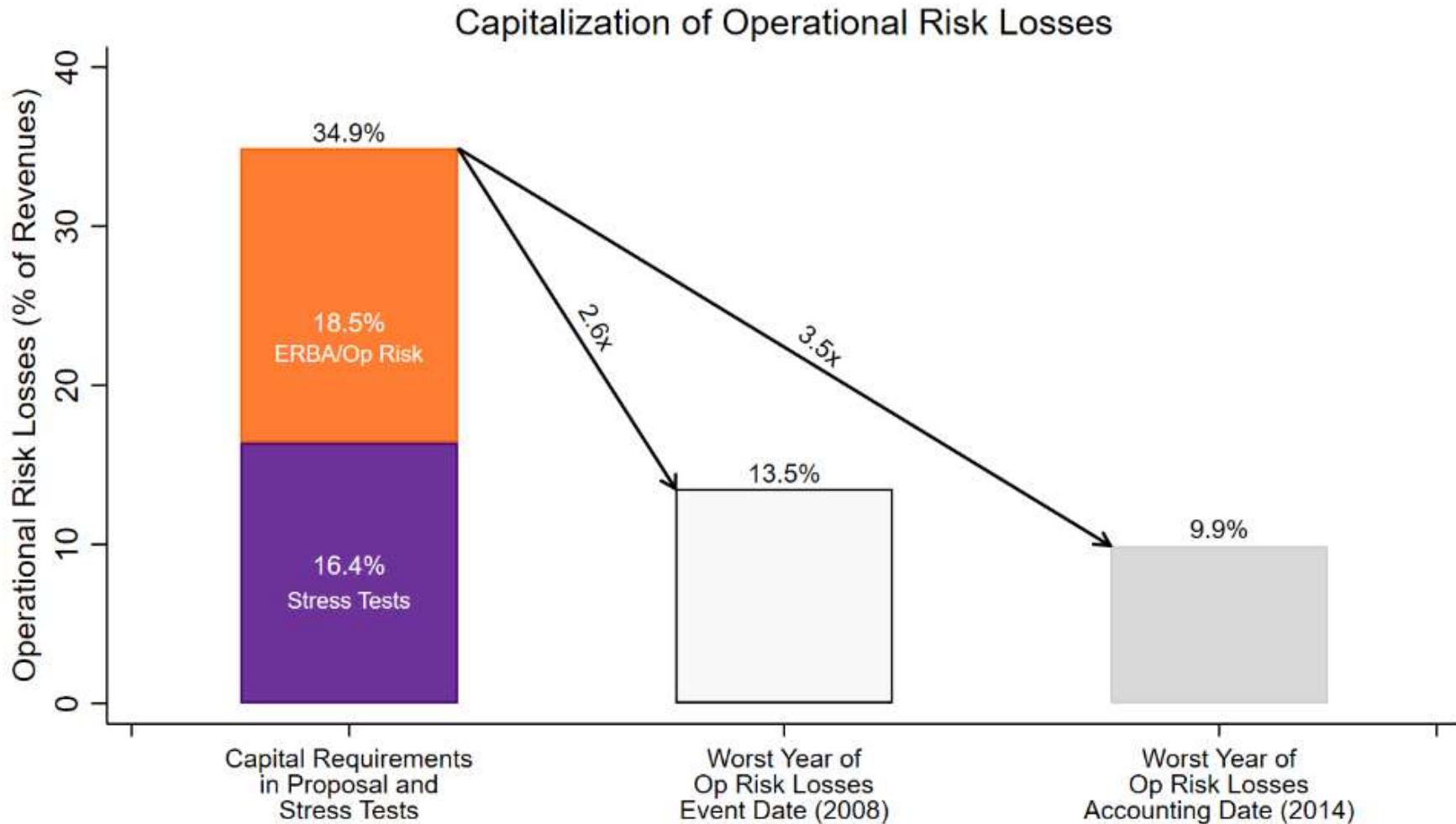
- Governor Waller’s July statement on the proposal raised several important issues that the industry considered in developing its comments; in particular:
  - Whether operational risk RWA estimates corresponded to observed operational risk losses.
  - The absence of an effort in the proposal to rationalize operational risk RWAs with related operational loss projection analysis in the Fed’s stress tests.
  - Timing mismatches between operational losses and credit and market losses, which suggest operational risk losses require a distinct capitalization approach.
- We agree with these points as key conceptual questions. Our comments submitted in January expanded on these issues and drew attention to several others, specifically:
  - Ways in which the issues noted above, together with the failure to consider the total aggregate operational risk charge — attributed not just to the ERBA but also the SCB, and further exacerbated by the GSIB surcharge — result in an overly excessive capitalization for operational risk.
  - How the “services component” of the operational risk capital charge would impact fee- and commission-based business models.
  - How the design and calibration of the “Internal Loss Multiplier” (ILM) component of the operational risk capital charge would further overstate risk-weighted assets.

# There is little correlation between operational risk losses and credit risk losses.



Note: Operational risk losses are measured using the accounting date between 2008 and 2014.

# Total required operational risk capital would far exceed historical losses.

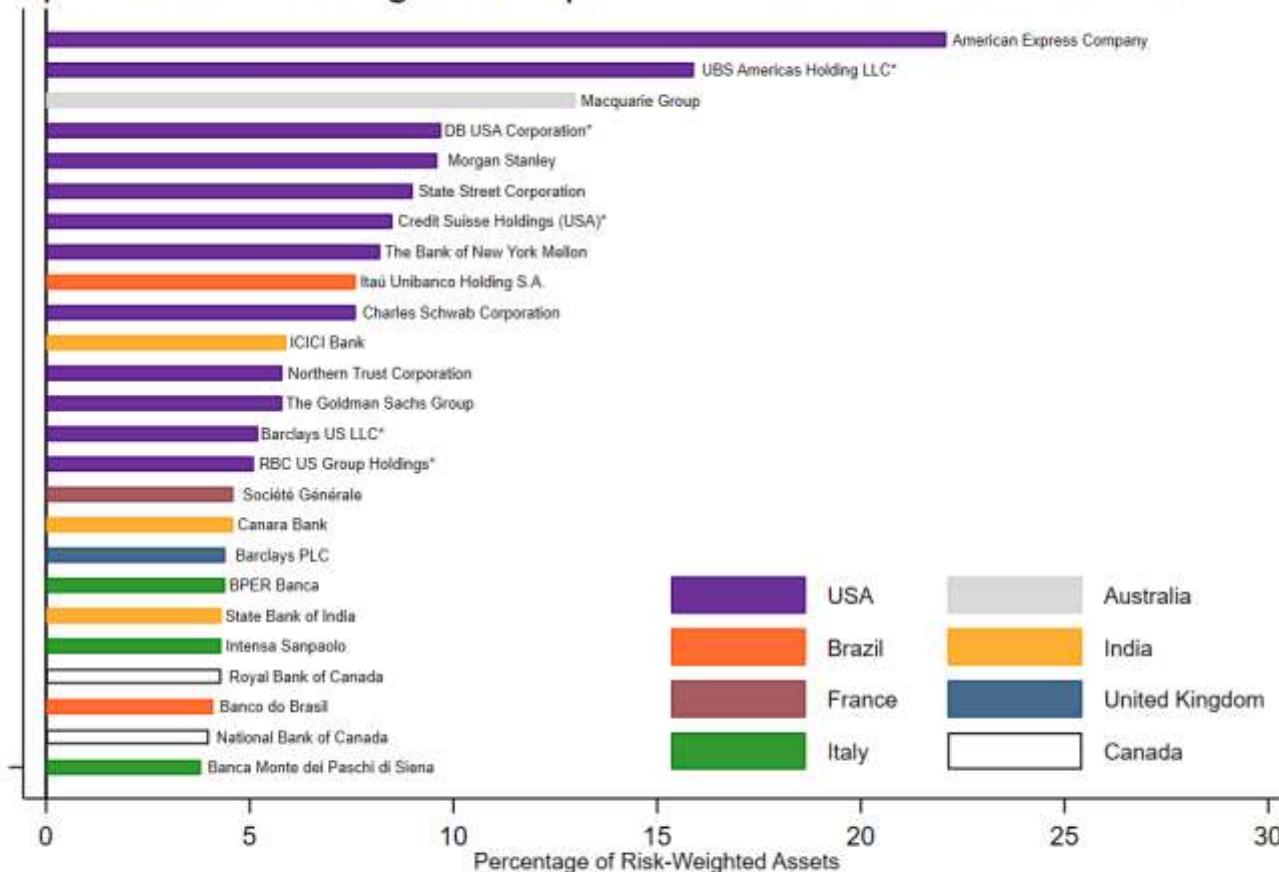


# **Significant downward adjustment of operational risk charge is necessary and appropriate.**

- The agencies should consider the calibration of the overall capital requirements for operational risk across RWA, SCB and the GSIB surcharge, which the NPR does not.
- Operational risk RWA is additive to the binding capital stack, and there is no discussion in the proposal of whether or how ERBA credit risk weights have been appropriately recalibrated to account for this.
- Operational risk capital is particularly punitive for GSIBs, due to higher BIC multiplier for larger banks as well as the higher capital requirements from the surcharge itself.
- It is important to consider both the magnitude and the distribution of the reduction achieved by any adjustments to the operational risk framework.

# Operational risk methodology is particularly punitive for banks with high fee income, many of which are in the United States.

Top 25 Banks with Highest Proportion of Noninterest Income Worldwide



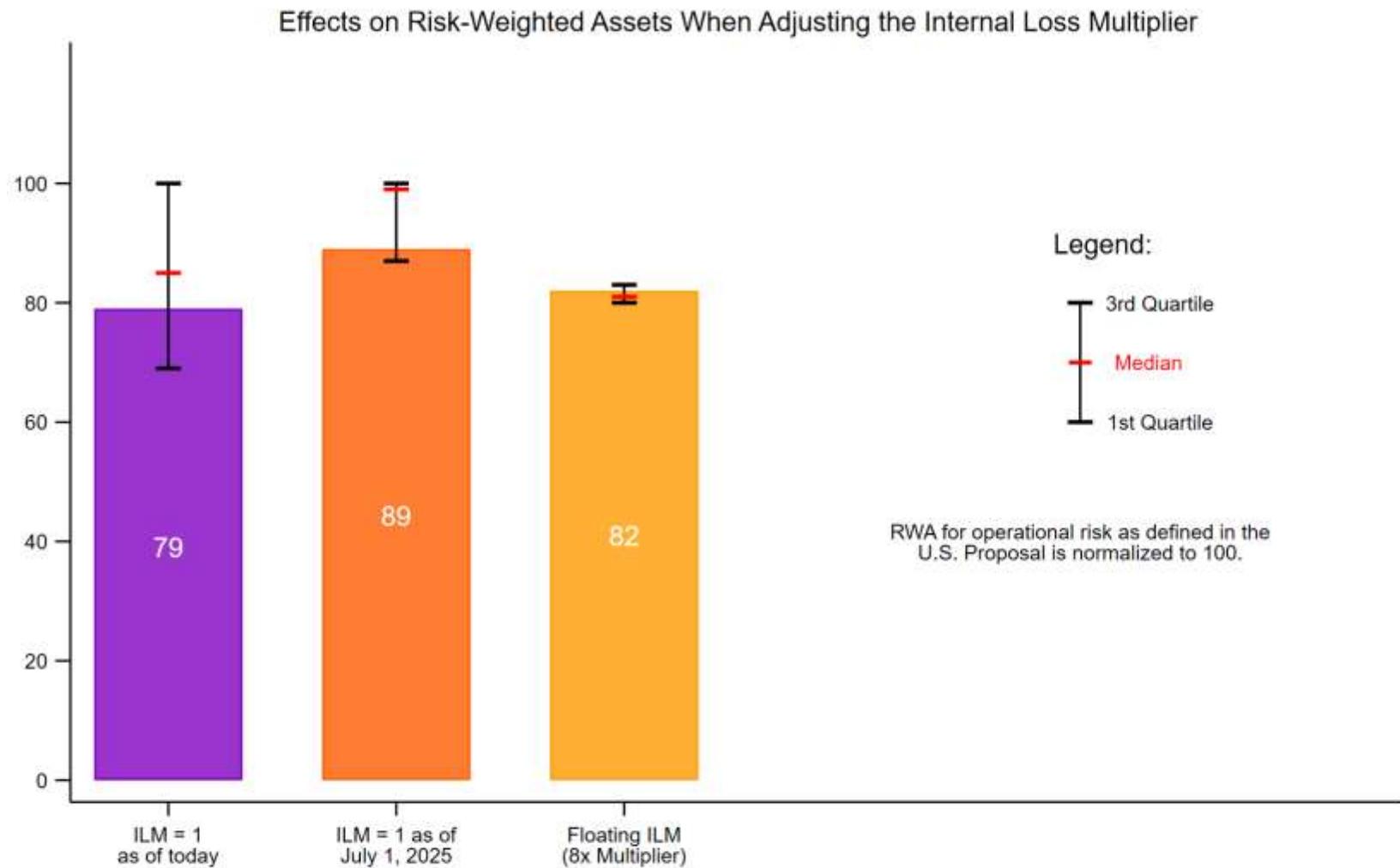
Note: \* Indicates the entity is a U.S. subsidiary of a global bank.

Source: S&P Global Market Intelligence.

# BPI Quantitative Impact Study of Possible Operational Risk Adjustments

- BPI members participated in a quantitative impact study to examine the effects of different potential adjustments to the operational risk framework.
- Collectively, these banks represent approximately 70 percent of total RWAs for operational risk under the proposal.
- Sample included universal banks, high fee income banks and banks with business models focused on lending.

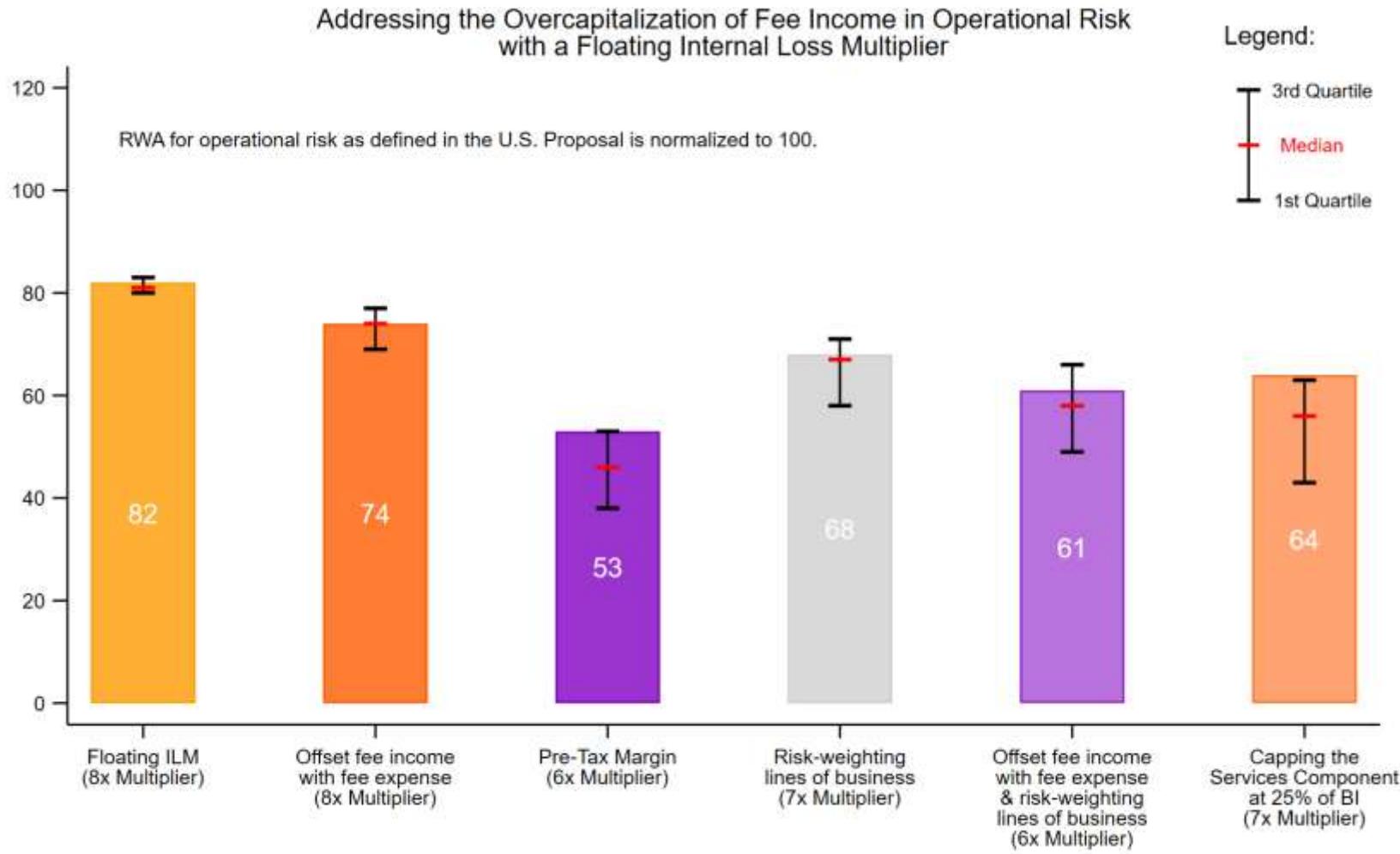
# Effects of Potential Adjustments to the ILM



# Key Findings on Possible ILM Adjustments

- It is important to address the broad-based overcalibration of operational risk capital requirements under the proposal as well as the calibration of the services component of the RWA charge.
- Simply setting ILM to 1 would not adequately address the excessive calibration of the operational risk charge for many banks, due to large GFC-related operational risk losses rolling out of the 10-year ILM window by the proposed implementation date.
- About half of the banks would experience no change in RWA for op risk, as their ILM is expected to be at or below 1 by the time the rule is proposed to be implemented.
- Allowing the ILM to float with a 8x multiplier and without the floor of 1 would reduce RWA by about 20 percent and more uniformly across banks.
  - Moreover, reducing the services component would lower the BIC, consequently leading to a higher ILM. Thus, a more material decrease in the services component necessitates a larger reduction in the multiplier for average annual operational risk losses used to calibrate the floating ILM.

# Effects of Potential Adjustments for High-Fee Banks



Note: Numbers inside the bars represent the weighted average.  
Source: BPI QIS.

# Key Findings on Possible Adjustments for High-Fee Banks

- One straightforward adjustment would be to apply a haircut to gross revenues using the publicly disclosed pre-tax margin percentage (dark purple bar in previous slide). This approach is similar to netting but would also deduct expenses from fee income even when those are not directly linked.
- Moreover, as noted above, adjusting the services component will result in an increased ILM, assuming all other factors remain unchanged. Therefore, making the average bank indifferent between ILM equal to 1 and a floating ILM under the pre-tax margin adjustment, would require setting the ILM loss multiplier to 6x average losses.

# Interplay between market risk and CVA elements of the Basel Proposal and GMS in the stress tests

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# Without adjustments, market risk and CVA risk capital requirements would be significantly overcalibrated.

- Governor Waller's July statement acknowledged that a large portion of the proposed capital increase would be driven by market risks already captured by the stress tests. Our January letter further explained why this is the case.
- Both the proposed FRTB and GMS assess market risk under extreme conditions and assume prolonged periods of illiquidity during which banks are unable to hedge or close out positions.
- CVA risk is already addressed in the GMS and the large counterparty default components of the supervisory stress tests, and the new standardized CVA capital charge would be completely additive.
- The Federal Reserve and other agencies should consider:
  - Recalibrating the GMS by modifying the assumption of no liquidity over an extended period of time to one of limited liquidity;
  - Recalibrating the GMS by removing private equity from the GMS and instead forecasting private equity losses as part of the macroeconomic scenario in PPNR;
  - Recalibrating the assumptions related to loss given default in the stress test loss projections; and
  - Excluding CVA losses from the SCB; and
  - Not applying the SCB to capital ratios determined under ERBA.

# Lack of tailoring of the Basel Proposal

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# Basel Proposal is not appropriately tailored.

- We agree with Governor Waller's concern, highlighted in his July statement, that the proposal does not meet the Federal Reserve's requirement to tailor capital regulation, and discussed this point in further detail in our comment letter.
- The proposal would largely apply the same capital requirements to banks in Categories I through IV and does not comply with statutory tailoring requirements.
- Particular issues due to lack of tailoring include:
  - Proposed changes to the definition in regulatory capital do not account for the fact that existing differences allow for differences in business models between broad commercial banks and other banks.
  - Requiring Category IV banks to apply a dual-stack approach would impose undue costs and burdens without a commensurate supervisory or policy benefit.
  - Applying the new market risk capital rule even to firms with immaterial trading activity would subject many firms to operationally burdensome requirements with minimal—if any—supervisory benefit.

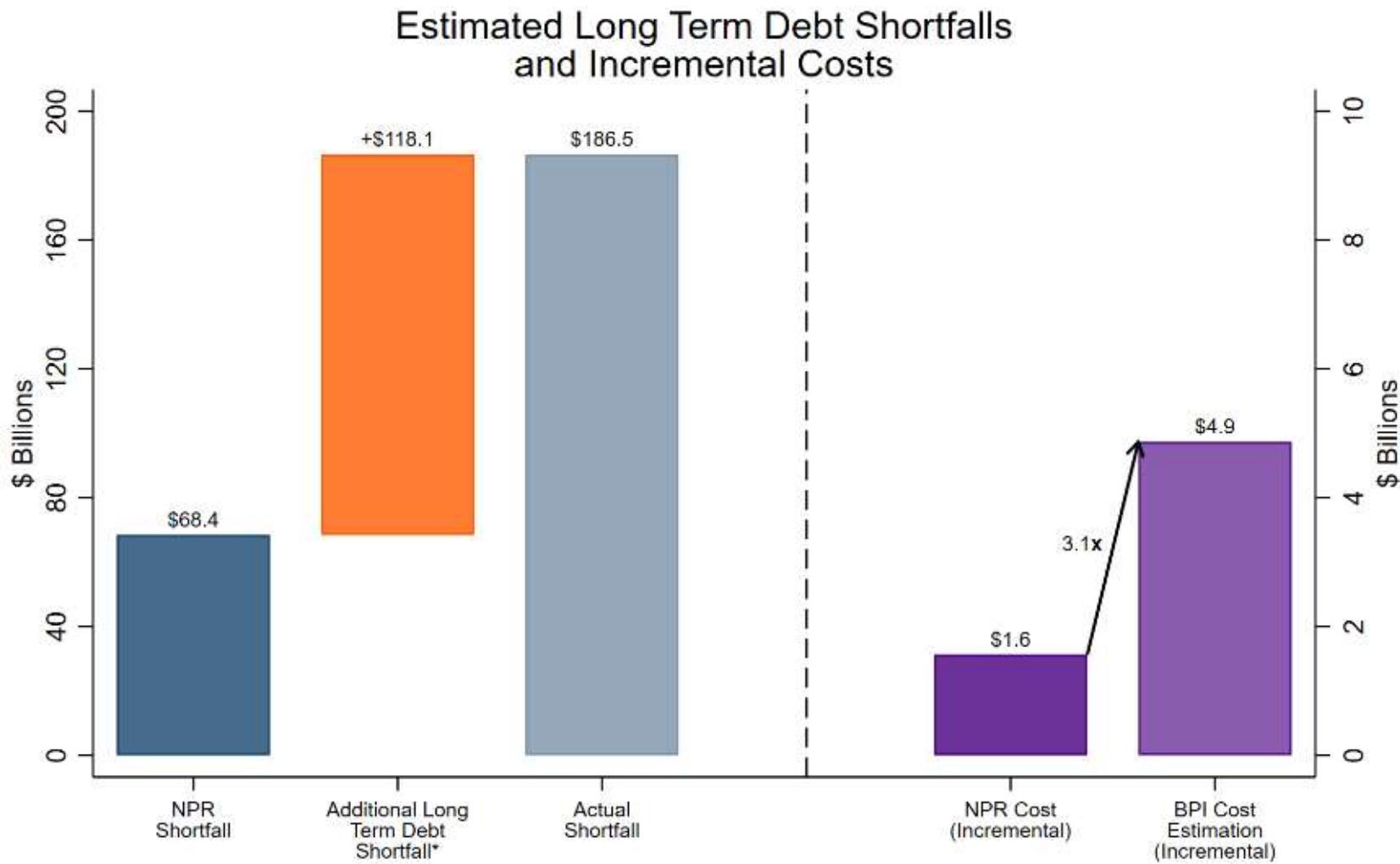
# Long-Term Debt Proposal

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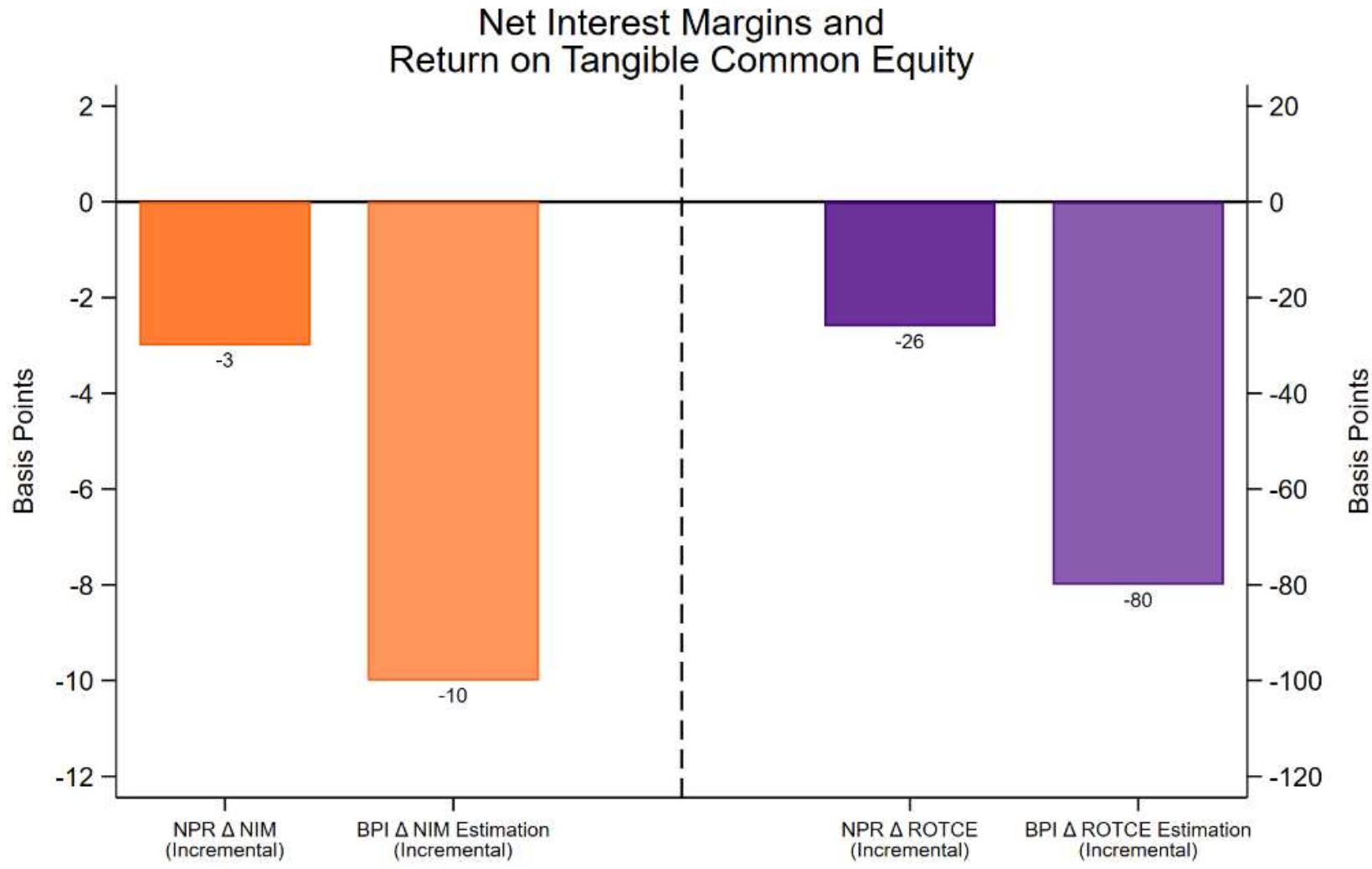
# Proposal severely underestimates the costs to covered banks.

- BPI estimates that the costs of the proposed LTD requirements would be **three times** the estimate in the proposal.
  - Based on estimates for LTD requirements, shortfalls, and bond spreads (shown in subsequent slides), the total bank funding costs for Category II through IV banks are projected to reach \$4.9 billion, which is three times the proposal's estimated costs of \$1.5 billion under the incremental shortfall approach.
- To address this overcalibration, the agencies should adopt an alternative calibration of **two percent of RWAs** instead of the agencies' proposal of six percent (and revise any leverage-based LTD requirements commensurately).

# Proposal significantly underestimates the LTD shortfalls and incremental costs.



# Proposal significantly underestimates the covered banks' costs of issuing debt.



# Proposal's internal debt and minimum denomination requirements are also problematic.

- Requirement that a bank must internally issue debt to its holding company, if it has one, would create operational complexity and would drive a significant portion of the underestimated costs, such as by interfering with liquidity coverage ratio compliance.
- Proposed \$400,000 minimum denomination requirement should be eliminated.
  - This is a solution in search of a problem; direct retail investment in long-term debt the United States has been historically very limited. Federal Reserve data used for the agencies' own estimates show that only ~1% of households buy corporate bonds *of any kind*.
  - Industry standard denomination is \$2,000, and where the GSIBs currently have the LTD requirement, more than 90% of GSIB long-term debt trades under \$400,000.
  - Minimum denomination of \$400,000 would exclude many institutional investors. By some estimates, less than half of key institutional investors (e.g., mutual funds and ETFs with a fixed income portfolio tracking the U.S. Aggregate Bond Index) are large enough to make such a large allocation to a single bank. Additionally, institutional investors often distribute across separately managed accounts, which requires lower denominations.
  - A minimum denomination requirement would be inconsistent with the disclosure-based framework of the federal securities laws.

# Stress Testing

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# Stress Testing

- As a general matter, the lack of transparency around the model design and plans for the longer-term path for supervisory stress testing to incorporate the effects of CECL, changes to the capital rules, etc. continues to be a concern and makes it difficult to engage in effective long-term capital planning.
- In connection with reconsidering the Basel proposal, the Board should put out for comment the stress testing policy statements and more generally solicit views on how to reconcile stress testing/SCB with any changes to the capital rules.
- Even apart from Basel finalization, the Board must act on our outstanding petition for rulemaking requesting that all models, formulas, scenarios and other decisional methodologies that the Board uses to calculate the SCB, including models used to project credit losses, go through a formal APA notice-and-comment rulemaking on an annual basis.
- With respect to the multiple scenarios being used in this year's cycle, the Board should not publicly disclose the results of the exploratory scenarios, at least not on an individual firm level.

# Liquidity

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# **Changes to liquidity regulation, if any, should only be proposed after comprehensive review and public engagement.**

- While many ideas for regulatory revisions have theoretical merits, it is imperative to think about them in a comprehensive way that considers the impacts across all business models, relevant regulations and markets.
- Given the wide range of liquidity changes under consideration, the high stakes involved, and the complexity of the task, we would strongly recommend that the agencies invite public input through an advance notice of proposed rulemaking or a request for information before proposing any changes.

# Reg II Proposal

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# **30% reduction in the interchange fee cap would exacerbate harms to consumers and financial institutions.**

- Contrary to predictions at the time it was imposed in 2011, the current interchange fee cap has not reduced prices for consumers or benefited small businesses.
- Lowering the interchange cap would reduce issuers' resources to innovate to combat fraud, imposing significant consumer harm.



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